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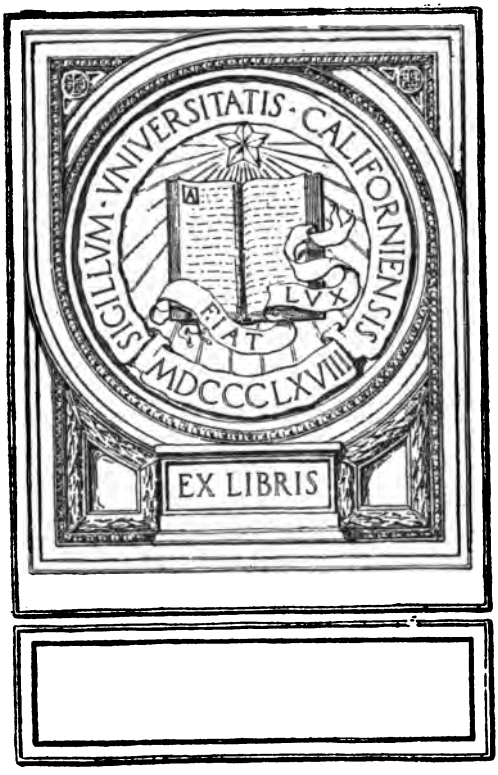
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THE

MODERN BALANCE SHEET

AN

ANALYSIS OF COMPANY FINANCE.

BY

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With HISTORICAL CHAPTERS by

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Author of "The Law and Practice of Joint Stock Companies," "Responsibilities of Directors under the Companies Acts," Etc.

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GENERAL

PREFACE.

THE pages that follow are intended to draw the attention of the shareholder to the grave defects which are to be found in the modern balance sheet. Under a system of accountancy, which has been allowed gradually to come into use, the statements of accounts, issued by the limited company, seldom convey to the public "a true and correct view" of the company's financial position.

It is submitted that the audit of the balance sheet—whatever reforms may be brought about by the provisions of the new Companies Act—has been hitherto little more than an idle formality in the majority of cases, and that the figures published by many companies, after inspection and certification by salaried chartered accountants, are without justification, and are calculated to mislead. Reprints of balance sheets are examined in Chapter IV., and it is shown

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that the shareholder, who knows nothing of the subtleties of board-room finesse, is easily led to believe that the concern in which he has invested his money is in a flourishing condition, while "rank corruption, mining all within, infects unseen."

False reserve funds are created by an over-valuation of assets, or by the investment of a surplus in stock-in-trade; goodwill is inflated without any reference to legitimate profits; depreciation of plant is grossly under estimated, and the convertible value of the assets is invariably exaggerated.

It is pointed out that the only safe test of a company's position is a comparison of cash assets with cash liabilities, and that unless that test is applied the shareholder cannot learn the truth. The question how the profits of a company should be calculated is answered after the consideration of recent judicial secessions from the old school of economics which insisted upon a distinction between fixed and circulating capital; and it is indicated that any payment of a dividend which would diminish the profit-earning

efficiency of a company is contrary to the intention of the Legislature.

Mr. Anthony Pulbrook, whose books on joint stock company law are well known, has contributed the first three chapters, which give an excellent outline of the evolution of the balance sheet.

GRAY'S INN, 1908.

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THE MODERN BALANCE SHEET.

CHAPTER I.

ORIGIN OF ACCOUNTS.

Primitive transactions—The Early Merchant—Evolution of Exchange—Foreign trading begun—The Bill of Exchange—Europe's dealings with England—"Bills obligatory."

When Adam delved.—The keeping of accounts is a natural development of the introduction of the system of credit in commerce. Before credit was given or required accounts were unnecessary. In the simple form of society, when wealth was represented by flocks and herds, there were no transactions to be recorded outside those flocks and herds. An increase of the number of cattle constituting a herd from 500 to 1,000 could be seen, so likewise could a decrease, hence the mere counting of the flock would enable its owner to know the extent of the increase or diminution in his wealth. Even if two individuals were owners of a herd as partners they could arrive at their separate rights by the simple process of dividing the herd. In the early days of commerce when it took the form of barter, an owner of cattle who

wished to exchange one or more of his herd for corn or raiment would have that corn or raiment delivered into his possession on the exchange taking place, thus the transaction would be completed, and there would be no necessity to keep any record of it. The same completion of a transaction of exchange occurred when metallic money — gold and silver — came into existence in the place of barter, the cattle being then exchanged for pieces of metal (money). The result of the transaction would be that the owner of the herd instead of arriving at an estimate of the extent of his wealth by counting the number of head of cattle constituting his herd would count in addition the number of pieces of money he had in his possession, a proceeding no different from that adopted at the present time in arranging a balance sheet to ascertain what is required to obtain an equilibrium of balance between the Dr. & Cr. sides by counting the pieces of money in hand.

The Middle Man.—When a tiller of the soil, who had spent all the pieces of money in his possession, wished to make preparation for sowing further crops, he would go to his neighbour, the keeper of a herd, and ask him to deliver cattle or hand over money immediately, upon promise that payment should be made at a future date, when the crops came to maturity. If the owner of the cattle had confidence that the tiller of soil would hand over to him at the

proper time, corn or money, he would entertain the proposal, thereby giving what is called credit to the tiller of the soil. When, however, the soil or climate of one nation was fitted for raising cattle, and that of another for growing corn, it became necessary to transport the cattle to the nation suitable for growing corn, and the corn to the nation suitable for rearing cattle.

This necessitated the introduction of an intermediary in whom both parties had confidence. By doing this the parties would not be taken from their vocations to visit distant countries, and this intermediary was termed a merchant. If both had confidence in this merchant, each would be willing to deliver to him his commodities without receiving in exchange the property to be given for them, and would thereby give him credit that he would obtain that property before he parted with the commodities handed to him. This merchant would not confine his business to transactions of exchange between A and B only, because it would be apparent that if he would act for C, D, E, and F as well, a great part of the expense of carrying out the exchange could be saved to each party. For instance, if a ship had to be employed, and if that ship had capacity to carry the commodities of all, the expense of the ship would be divided between all parties.

In order to arrive at a fair determination what to charge to each, it would be necessary for the merchant

to keep an account of the total aggregate cost and then divide it between the parties in proper portions. The owner of the herd, deriving no benefit from simply contemplating the extent of his wealth, would endeavour to acquire a tangible advantage from its possession; for instance, he might do so by obtaining luxuries from foreign climes. To effect this the services of a merchant would have to be enlisted to obtain them for him. The producer of these luxuries, deriving no advantage from their possession, would likewise be anxious to exchange them for more useful commodities, and he also would invoke the aid of a merchant who would act as intermediary for the purpose. He would thus have to effect exchanges between a number of parties, and for this purpose it would be necessary for him to keep accounts. In some cases instead of acting as agent for particular individuals the merchant, by trading between nations, would discover that there was a general demand in one country for the specific productions of another; then, without knowing exactly with whom he would effect the exchange, as money in the shape of gold or silver was a common measure of value in all countries, he would place a measure of value in these metals as exchangeable commodities for the articles acquired by him in one country to exchange for commodities of another.

Gold and Luxury.—If the producer of the luxury received a certain weight of gold or silver in exchange

for that luxury, he could probably obtain in his own country a commodity he required in exchange for that gold or silver, or he would deliver the luxury to the merchant and give him time to obtain the gold or silver from the country requiring the luxury. In such cases it would become necessary for each party to make a record of the transaction, the luxury handed over, the amount of gold or silver to be brought back for it, and the time within which it was to be brought back, and this record would be reduced to writing. Thus the merchant, from being only the intermediary in whom both parties had credit, gradually dealt with others in each country who wished to exchange other commodities. By so enlarging his original engagement to bring back in exchange for the luxury a commodity from another country, which the owner of the luxury required, he might engage to bring back so much money. In this case to carry out the business, a writing signed by the merchant recording the period within which he was to bring back the money and the amount of money to be brought back would be given in exchange for the luxury. Then it is only a step further for the owner of the luxury, knowing that with the money he could obtain what he wanted in his own country, to seek to exchange the record representing the time and amount of money the merchant was to bring in exchange for the luxury to obtain the commodity he required without payment of present money. With this object he would go to someone living in his own country, who had the

commodity he required, and producing the document he had obtained from the merchant, ask him to deliver him the commodity at once in exchange for the document, and an order to the merchant to pay the money to the owner of the commodity. If this individual gave the merchant credit for carrying out his engagement he would make the exchange. Here we have all the essentials of a Bill of Exchange—a statement of the commodities given by A to B, an acknowledgement by B of the receipt of those commodities, and a promise by him to pay the measured value of the same at a particular time and place. Thus the indiciæ of title symbolizing the commodities in respect of which they were given would come into use as negotiable documents, and it is clear how it became a custom amongst merchants for mutual convenience that a document of this nature should be treated as a negotiable instrument, conferring a right on the holder to whom it had been transferred in proper form by indorsement to receive the money, whatever might be the state of accounts between the two original parties. It would follow that a merchant having one of these documents payable in the country he proposed to deal in, instead of carrying the precious metals about with him, and thereby inviting robbery or murder, would go armed with the pieces of paper which for this object were to all intents and purposes as good as money in the country he was journeying to.

If A and B, for example, were merchants, and

resided at Venice, and A had bought corn in Egypt, where he had credit, for which he had given his acknowledgements to pay, and his ship was laden with the corn, and B had in like manner bought wine in France, where A was unknown and had no credit, these symbols of credit enabled A and B to exchange their commodities with one another so that A could deliver wine obtained on B's credit in France to Egypt in exchange for corn, and B could deliver corn in France obtained on A's credit in Egypt, because A and B had credit in each other, and the only money in the shape of metals they would require to exchange would be the amount of balance of profit made by each.

An Early Physiocrat.—The correctness of these conjectures is borne out by a very old author, Gerard de Malynes, in a work published in 1622, entitled "Consuetudo vel lex Mercatoria," or "The Ancient Law Merchant." This contained a chapter entitled "Of the revolution of buying and selling of commodities by the course of traffic," which it stated took place "because the commodities of one country growing rank and abundant are transported into other countries; in whose stead needful commodities of those kingdoms are returned thither, which is a neighbourly lending between Kingdoms and Countries. For as is noted God caused nature to distribute her benefits or His blessings to several Climates of divers things found in some places that

are not in other places to make an interchangeabe course of the said commodities by way of Merchantising."

* * * * *

"This revolution . . . may be illustrated by the consideration of the several means whereby the said buying or selling are effected: 1, with ready money; 2, a buying and selling of Commodities payable at some limited time; 3, another buying and selling of commodities to be paid by Bills of Exchange to be paid in another place; 4, another merchant having money in bank, goeth to the bank and assigneth the seller of the said commodities to receive so much money there; 5, and another hath a letter of credit; 6, the most usual buying and selling of commodities beyond the seas in the course of Traffick as by Bills of Debt or obligations called Bills obligatory which one merchant giveth unto another for commodities bought or sold which is altogether used by the Merchant adventurers at Amsterdam, Middleborough, Hamborough, and other places, for when they have sold their clothes unto other Merchants or others payable at 4, 6, 8, or more months they presently transfer and set over these Bills (so received for payment of their clothes) unto other merchants, and take for them other commodities at such prices as they can agree with the sellers of those, be it Velvet, Silks, Satins, Fustians, or any other Wares

or Commodities to make return of the produce of theirs and so selling these foreign Commodities in England, they presently bring more clothes and continue a revolution of buying and selling in the course of Traffic and Commerce being so (in effect) as may be illustrated by example."

A Word to England.—He then goes on to say that, "The Common law of England is directly against this course for they say there can be no alienation from one man to another of Debts, because they are held 'Choses in action' and such whereof no property can pass by assignment or alienation." He concludes the chapter by suggesting: "This custom might (with great facility) nevertheless be established in England." He gives the form of a Bill obligatory as follows:—"I, A.B., Merchant of Amsterdam, do acknowledge by these presents to be truly indebted to the honest C.D., English Merchant, dwelling at Middleborough, in the sum of Five Hundred Pounds Current Money for Merchandise which is for Commodities received of him for my contentment which sum of Five Hundred Pounds as aforesaid I do promise to pay unto the said C.D. (or the bringer hereof) within six months after the date of these presents. In witness whereof, I have subscribed the same at Amsterdam the 10th July 1622 *stilo novo.* A.B."

He writes of these Bills in England as follows:—

"In England Bills Obligatory, being made payable

to the party his Heirs, Executors, Administrators, or Assigns, may conveniently be set over as aforesaid because the lawful assignee shall be of record and registered also upon the Bill and if there be two or more bound in a Bill fraudulent dealing will also be better prevented."

As these transactions increased in number a necessity would arise for merchants to arrange some system whereby they might be able to keep a general record of them without trusting to memory and from this no doubt originated the system of Book-keeping, that is, making records of each transaction in books kept for the purpose.

CHAPTER II.

ANCIENT ACCOUNTS.

Malynes' de, work—Anecdote of Henry VIII. and his jester—An historical reform—Origin of Double-Entry in Italy—Its progress to this country.

The Wisdom of Italy.—De Malynes concluded his book with a chapter "On Merchant Accounts kept by debtor and creditor," as follows:—

"The manner of keeping accounts by Debtor and Creditor, was first devised in Italy upon very good considerations. There is a great affinity between Faith, Trust and Confidence."

"He that is trusted with any goods . . . is therefore called a Debtor or Debtors unto the party that trusted him therewith and he calleth that party his Creditor, because he gave him credit for the same, whereby Debitor and Creditor concurreth between party and party."

After detailing the mode of starting the Books of a young man "desiring to deal in the work of Traffic," he goes on to say, "He maketh a stock or capital which he doth enter in a book called a Journal because it contayneth his dayly actions from time to time; and from this book they are transferred or set over into another bigger book

called a Liedger because the same remaineth (as lying) accordingly in a place for that purpose. The Spaniard doth call this book El Libro Grande and the Journal he calleth Manuall being a far lesser volume, commonly but one-third part of the latter."

The King's Jester.—He next lays down the principles "that every Debitor must have a Creditor" and "every Creditor his Debitor" and that the left side of the Liedger (p. 11) is the Debitor's side and the right the Creditor and that in the Journal the Leaves or folios of the Liedger are noted over a line in the margin for a Debitor and under the said line for the Creditor." He further records "That the great Marchants 'will arm an account' which is the Spanish phrase 'armar una cuante' put in plain English. They will keep an account for themselves and make their warehouser Debitor because the warehouser is trusted with the wares . . . Others will make the Commodities Debitor and their own capital or stock Creditors. In like manner after referring to their moneys in a chest . . they imagine this cash to be a person whom they have trusted and make the said Cash a Debitor for the money they put into it and when they pass out that money or any part thereof they will make Cash Creditor and that party to whom it was paid shall be made the Debitor." The writer adds, "You must still have a care to find Debitor to have his Creditor and every

Creditor must have his Debtor," and illustrates this by a quaint anecdote of William Sommers, jester to Henry VIII. "When the King told him that he delivered a good sum of money unto a Gentleman, a follower of his, Sommers answered that for so doing he had noted in his book that the King was a fool, giving his reason for it because the Gentleman would never return back again and that the King was cozened. But the King asked of Sommers what he would do in case the gentleman did return with the money; whereupon Sommers answered, Then I will put him in my Book for a fool and put you out." The writer adds of the Liedger, "the main ballance of the whole Book must not differ one penny."

The writer next relates that "the French King Henry IV. calling to remembrance his former observation by comparing things to their first principles found that there came not above a fourth part declared unto him, whereupon by rooting out of corruption, deposing of needless officers . . . he brought (*e contrario*) three parts of every Crown into his coffers and did in progress of time accumulate a very great Treasure."

The Love of Darkness.—A conclusion to this work contained the following remarks—which we commend to the notice of shareholders when accounts are withheld from them because their publication might damage the company. "True it is that the

ancient monarchies, empires and commonwealths held the knowledge of their Revenues in such reverence and secret that none but the officers which had the managing thereof were made privy of them as being secret things not fitting that the people should take notice thereof . . . so was it found that by this secrecy officers were both emboldened and enabled to deceive their princes thereby and the people would pretend ignorance to give to them their dues; whereupon the Senators of Rome by mature deliberation did ordain that from that time forward the revenues of their Treasury and their dependencies thereupon should be published and made known not only unto the people but unto strangers also which the Emperor Justinian caused to be observed and other Emperors succeeding him as appeareth by the Code and other Books which the French Kings have imitated, ever since willing and commanding that these things should be known of every one, yea even of the mere strangers of other countries. So that this objection is of small moment." He adds, "Some philosophers have established three beginnings of natural things, Matter, Form, and Deprivation. The matter hath no other office or function but the changing of one form into another, deprivation giving an inclination thereto. For Deprivation is an imperfection so conjoined into the matter that without her if she were separated nothing could be engendered and therefore in Heaven there is no

depreciation and therefore no generation nor corruption.

* * * * *

"No man is to be dismayed at his small talent or to grudge at another's great prosperity; for without doubt Nature hath by her secret creation denied none some perfect quality to supply that want which in others breeds discontent or dislike."

From the foregoing remarks it will be understood how it was that the proper keeping of accounts is first recorded as having taken place in countries whose foreign commerce was originally carried on to a greater extent than in other nations, and as commerce extended from one nation to another, so the art of keeping accounts travelled with it. Italy being the cradle, as it were, of foreign commerce, we find that the system of double entry, now generally adopted, originated in that country, and in the earlier works on the subject is usually, termed the Italian system. As Holland became a centre of foreign trade so the system is recorded to have travelled by way of Nuremburg to that country.

CHAPTER III.

EARLY WORKS ON BOOK-KEEPING.

Italian and Dutch books—Hugh Oldcastle—Peele's "Admonition"—Ancient Law Merchant—Daffornе's Dialogue—Early Double Entry—Postlethwayt — His Dislike of Secret Accounts — Commerce but a game.

Pathwaye to Perfectness.—The earliest recorded works on bookkeeping were published in Italy and Holland. From the latter country the practice travelled to England.

The first English work specially devoted to the subject appears to have been written by one Hugh Oldcastle in 1543, but no copy is known to be in existence. There is a black letter work extant in the British Museum Library by James Peele, written in 1553, entitled "The Manor and Forme, howe to keep a perfect reconying after the order of the most worthie and notable accompte of Debitour and Creditour set forth in certain tables with a declaration thereunto belonging verie easie to be learned and also profitable not only unto suche that trade in the facte of Marchaundice but also unto any other estate that will learn the same."

This book contained an exhortation "to learn

Sciences, especially of the accoumpt in the trade of marchaundice."

In 1569 he published another work for "the more amplifiynge and playne setting forth thereof," entitled, "The Pathwaye to the Perfectness in the Accompte of Debitour and Creditour in Manner of a Dialogue very pleasante and profitable for Marchauntes and all others that minde to frequente the same once again set forthe and very much enlarged by James Peele Citizen and Salter of London, Clerk of Christes Hospitall practizer and teacher of the same."

The writer in his Preface remarked "Every particular man should right well perceave upon presente viewe of his books the state of all his thinges with all men as well generall as perticuler."

The date of the publication of this work, 1569, was the date given by Macpherson and Anderson, as that at which "The Italian mode of Bookkeeping is usually supposed to have been introduced and adopted by English Merchants." It would appear that it was known before that date. This work of James Peele contains a "briefe admonition" which is as pertinent to-day as when it was written. The following is an extract :—

> Eache man that holdeth a householde in charge,
> Whose hope is to have God's bountie at large
> With diligent care and studious paine
> Must still be mindefull his state to maintain.

And specially with you that deale with great and long accounts,
Whose reckonings oft are intricate, whose charge right farre amounts
Above the common rate on whom both oftymes depend,
The weak and welfare or decay of thousands in the end.

A work was written by John Mellis, Schoolmaster, in 1588, entitled "a Briefe Instruction and manner how to keep Books of Accompts after the order of Debtor and Creditor."

This author in his Preface states "I am but a rescuor and revivor of an ancient old Copie printed here in London the 14 of August, 1543 . . by one Hugh Oldcastle," and adds—

"It behoveth every good discreete Marchaund to have knowledge and cunning in reading and writing also to be prompt and ready in his accompt and reckoning . . . which reckoning in the parts of Italie is named Dare and Habere which in our language of English is called Debitor and Creditor."

Salarino's Fears.—When we see how items are lumped together in balance-sheets submitted to shareholders at the present day, the following instruction is interesting:—

"It is behoveful to name everything in due order in the said Inventerie with all the countersigns names and surnames as much as possible." This and the following remarks are instructive to directors who consider that all they have to do is to sit at board meetings.

"A merchaunt ought to be knowne more than a doctor of the lawe, for who is he that can number the chaunces that may fall in marchandising, what by sea and what by land, what in time of peace and plentie and what in time of warre, and in sickness and in health."

A later edition of Gerard de Malynes "Consuetudo vel lex Mercatoria" or "Ancient Law Merchant," was published in 1636. It contained a work entitled "The Merchants Mirror or Directions for the perfect ordering and keeping of his accompts framed by way of Debtor and Creditor after the so termed Italian manner, compiled by Richard Dafforne of Northampton Accomptant and Teacher of the same after an exquisite method in the English and Dutch language."

The preface to this work is very interesting and shows that the art of book-keeping was well-known in Holland, and that the proper keeping of accounts was an art but little followed in this country in those days. He writes as follows:—"After many years residence in Amsterdam in Holland I (upon the oft importunate letters of some Marchants my very good friends) resolved to pitch the tent of my abode in London which being effected in Anno 1630 I then (after some rest) set my course into several Stationers shops there gazing about me (as one reviving from a trance) to view what the laborious Artist had acted and divulged in Print (as other Nations) for the assistance of Merchandising where-

with (blessed to the great All) this renowned City is thoroughly entertained and adorned.

"But as a skipper anchoring upon an unknown Ile presently perceiving those parts not to be inhabited by the non-tillage or the like, even so, contrary to my expectation, I, perceiving the number of writers to be but few, feared that love for this art was but small . . . against the foresaid ignorance I 'have emboldened myself to prepare the antidote.'"

This quaint old writer concludes his Preface as follows:—

"Heart take thine ease, men hard to please
"Some haply might offend
"Though one speak ill of thee some will
"Say better There's an end."

No better definition of the importance of keeping proper books of account could be framed at the present day than that given by the writer of the work we are referring to. At page 4 he states "The end of Book-keeping is to give contentment unto the Book owner and to show him (or those whom they do concern) at all times and in every degree how his estate standeth in the so written Books."

Schoolmaster Abroad.—Dafforne is precise on points of book-keeping. "In place of the word Ballance" he writes: "I should rather enter estate Reckoning, for, by drawing the whole book to a head, I draw with one an account of my estate." He added "Ballance is either a trial or true

balance" which "ariseth from the Remainers of the Ledger Accounts as well in Money unsold wares, voyages, not wholly sold Houses, Lands, People, &c., not yet compleatly perfected and are therefore transported to New Books to be there fully finished." In the present day these would be carried forward into a balance sheet, as assets, and those reading the accounts would assume that they were realised profits.

It will be useful to extract the following two entries in the form of Accounts given by Dafforne in his dialogue between Pupil and Schoolmaster as illustrating his observations.

"The pupil remarks as follows—Suppose there were only part of those wares sold.

"Sch.:—Deal with them as here shall be shewed by this—

Debitor.		*Creditor.*	
Shipt 100 pieces of Cambric.		Sold 80 pieces for ...	£320
Cost with charges ...	£300	Unsold 20 pieces at £3 per piece	£60
Gained by the Sales ...	£80		
Pieces 100	£380	Pieces 100	£380

Then the pupil makes the following enquiry—Suppose that none of these sold.

"Sch.:—Deal with them as shall be shewed by this—

Debitor.		*Creditor.*	
Shipt 100 pieces of Cambric.		For 100 pieces wholly unsold carried to Balance at £3 each piece is ...	£300
Cost with charges ...	£300		

There was a work published by John Carpenter in

1632, entitled "A most excellent instruction for the exacte and perfecte keeping of Merchants Bookes of Accounts by way of Debitor and Creditor after the Italian manner." The writer dedicates the book to the East India Co., in whose service he was, and admits that he took it, for the most part, from the work of another, which is said to have been that by Hendrick Warmingham van Campen, published at Amsterdam in 1515. Dafforne referring to this work wrote that it was "nothing else but a general copy of Hendrick Warmingham's book, both in words and number of the questions." An address to the reader by Carpenter refers to this order and method of keeping merchants' account, which is "by the way of Debtor and Creditor; by the Italians called Dare and Habere," and in his Exact Instruction he says by "Debtor" is meant the "account that oweth" and by "Creditor" is meant the "account which is due to have," and adds the Debtor or Debtors being the charge, and the Creditor or Creditors being the discharge are in every parcel to equal one to the other.

The True Italian Method.—William Webster, a Writing-master, published in 1719, an "Essay on book-keeping according to the True Italian method of Debtor and Creditor by Double Entry whereon the theory of that excellent art is clearly laid down in a few plain rules and the practice made evident and easy by a variety of "intelligent examples."

This little work met with favour. It went through several editions. The 12th, published in 1755, was carefully corrected by "Ellis Webster, Writing Master and Accomptant." The writer starts with the following statement: "Book-keeping is the Art of stating our accompts so as rightly to represent the condition of our affairs to which end the Italian manner of Debtor and Creditor by Double Entry is by experience found most conducive." To this little work was attached by the same author another entitled, "An attempt towards rendering the education of Youth more easy and effectual" from which we extract the following:—"The next necessary qualification of a Clerk or Accomptant is the most excellent art of Italian Bookkeeping, a science beyond the price of words and without which a man is neither fit for the Cabinet nor the Compting House."

Craft and Craftiness.—A fourth edition of the "Dictionary of Commerce," compiled by Postlethwayt, was published in 1774. It contained valuable suggestions and information on the subject of accounts capable of being applied to companies at the present time. In its description of accountantship it stated "it comprehends not only a skill in figures or arithmetic, but a knowledge in the art of account keeping by debtor and creditor or by the method of regular charge and discharge according to the nature of the transactions which

method keeps every distinct account if they are ever so numerous always fit for a ballance and that ballance is found by substracting the sum total on the debit side from the sum total on the credit side or the sum total of the latter from that of the former." Under the heading "accounts," in describing this method it stated "these books are kept in the manner of debtor and creditor, that is to say, the debit which is the receipt of the account is wrote on the left side of the page and the credit which is expressed on the right side or page. . . The French instead of the words debtor and creditor use the words Doit (owes) and Avoir (to have). There are three kinds of accounts absolutely necessary for closing books of double entries, namely, the accounts of stock, of profit and loss, and of ballance. . . . The account of stock contains all the effects of a merchant. . . This kind of account is sometimes closed on the debit and sometimes on the credit side of the account of Profit and Loss."

In a later article the following appeared "But here it may be useful to observe that although the accounts must necessarily ballance by reason of the equality of debits and credit yet it does not from thence follow that such accounts are justly stated and truly represent the condition of people's affairs. For there may be very great fallacy and imposition by the stating of accounts artfully made under false and deceitful heads yet those accounts

shall as duly ballance as those which are fairly and honestly stated by reason of their being kept according to the method of double entry, but this renders no imperfection in the art, for fictitious entries may be as regularly stated and ballanced as real ones." And under the heading "Accountantship" the compiler further remarks, when speaking of the importance of lawyers' mastering the science of keeping accounts, that "they may be so craftily and sophistically stated as to deceive the most upright judge and jury as well as the council if they are not capable of unravelling them in the course of the pleadings."

The Open Door.—Postlethwayt goes on to suggest a remedy for fraudulent company accounts, which apparently developed into our present system of auditing. He advises that "gentlemen of the best education and knowledge of the world should make themselves compleat Accountants, otherwise how is it possible that they should be capable of examining into the state of the accounts of public corporations?" It is instructive to note that our legislature, in the form of Articles of Association known as Table A to the Companies Act, 1862, by Article 78, adopted his view when he remarked "And why should not the Ledger and indeed all the other accounts of bodies corporate be fairly laid before their general Courts? nay, should not every proprietor who is interested to a certain degree,

have this liberty, at certain stated times, if not at all times. By this means the man of penetration would be able to discern how the public business went on, and would be capable of preparing himself to speak to the interest of societies at their general Courts and who can do that to good purpose without a competent knowledge in the companies' negotiations? I must confess that I have not discernment enough to discover why the books and accounts of trading societies, any more than those of the public offices where the state of national revenue is registered, should be kept private when the interest of the public require otherwise."

"Who then" he demands "may we rely upon to watch over the conduct of great companies? To put the sole confidence in Directors no one will contend for who is at all acquainted with what is past. Who then is so fit to take care of public property as the public proprietors themselves? Such among them who are of the best abilities without doors should attend to the conduct of those within, should call for accounts and vouchers at their general Courts and go to the root of their affairs, before schemes can be formed and executed to the public detriment. This vigilant inspection, this constant scrutinising of the most judicious proprietors who have no share in the direction of public companies is certainly the way to prevent those calamities which have been so often experienced."

Commerce but a Game.—As regards a merchant's not keeping proper accounts, Postlethwayt made the following apposite remarks—"He must owe his success, if he has any, to fortunate hits and unexpected advantages, things which no prudent man will choose to depend upon for the prosperity of his life. To the ignorant in these matters, commerce is but a game of chance where the odds are against the player. But to the accomplished merchant it is a science where skill can scarce fail of its reward; and while the one is wandering about on a pathless ocean without a compass, and depends on the winds and tides to carry him into his port, the other goes steadily forward in a beaten track which leads him directly, if no extraordinary accident intervenes, to wealth and honour." And he illustrates his remarks by a practical example as follows:—"Had those worthy and honest gentlemen, Messrs. Woodwards, Bankers in Exchange Alley, London, been thoroughly masters of Accounts themselves, and regulated their books in that concise manner which the admirable art will admit of, the catastrophe which unhappily befel them, could never have happened, notwithstanding the extensiveness of their transactions."

CHAPTER IV.

ANALYSIS OF BALANCE SHEETS.

The illusory reserve—The real test of a balance sheet—"By gross profits"—Cash liabilities against cash assets—Dividend from deficit—Freeholds, leaseholds, and goodwill—Capital called up to appease bankers—Nervous employees—A curious case for reconstruction—Depreciation extraordinary—Two reserve funds and not a farthing invested—Expensive goodwill—A sound balance sheet.

Romantic Accountancy.—The historical chapters have been introduced to show that although the greater complexity of the present day commercial system has rendered necessary more elaborate accounts there is no reason why the fundamental principles of the old system should not be kept in view when the shareholder wishes to examine a modern balance-sheet. If the practice of book-keeping has been subjected to the vagaries of evolution since the Venetians sent their argosies, with portly sail, across the seas, the basis of accountancy has never altered. In those days there was a bluff materialism in the appraisement of assets and a relentless logic in the estimation of liabilities. The merchant, who told his beads with a monastic fervour before he trusted

his fortunes to the waves, counted his ducats with a Hebrew care as soon as the dangers of the deep were past. Even the emotion of the Ausonian imported no romance into the columns of a ledger, and, when Zenobe wooed his purchased bride, he was wont to see that she was properly represented in the books of his domestic corporation. It was left to another race and to another age to introduce the element of fantasy into a cash account, and the still sad music of humanity into a limited liability company, incorporated under half-a-dozen Acts of Parliament. Strange, as it seems, the nation that has come to regard the Union Jack as an asset, has managed to conserve just enough of the poetic sense and the artistic sensibility to relish in commercial documents a subtle and æsthetic mixture of the real and the ideal.

Dream in Silver and Conceive in Gold.—There is something irresistibly poetical in the simple, unwavering faith of thousands upon thousands of shareholders in limited liability companies that their capital is not only intact but is earning profits, which are being paid into a reserve fund to be used one day in expanding the enterprise that they support into a gigantic syndicate for the production of extraordinary percentages. The directors teach them, at quite a moderate expense, to dream in silver and conceive in gold. They pay willingly for their poetry, too. They forego half of the dividends which, the board

informs them, they might legitimately be paid, were it not advisable to augment the reserve, and, in return, they have the exquisite pleasure of believing in the financial security of the firm and of indulging in the harmless boast that their company, floated with such prescience a year or two ago, has amassed an emergency fund of £100,000.

Should there be many of the older school—the matter-of-fact, money-grubbing school—whose avowed object in putting their funds into a public company is to increase them as many fold as possible, without worrying themselves about such sorry stuff as poetry, they will do well to insist upon being supplied with balance sheets which actually convey a "true and correct" idea of the affairs of the concern. They will be told, no doubt, in the conventional language of the city that it would be unwise to publish a statement which would give too much information to any rival who might choose to read. They will be reminded by directors, with the diplomatic airs of ambassadors, that a certain element of the occult has been imported into company finance for the purpose of making the position of a firm appear to the best advantage in the eyes of a world that is still deceived by ornament. But, if they are discreet they will recognise that the words "by gross profit," with an adequate number of ciphers affixed, are expected to possess for those who do not haunt the street of Janus, a transcendental glamour which has really no money value; that "goodwill" is a

study in ontology, entrusted to interested amateurs, and that "reserve fund" has all the worth and all the attractiveness of an impossible belief.

The Touchstone.—There is but one test of a balance sheet that can satisfy the prudent shareholder and that is a comparison of cash assets with cash liabilities. All balance sheets contain a multitude of figures which do not represent properties that can be converted into money or be accepted as the security for money, when liabilities that cannot be postponed are to be liquidated. There are always liabilities which a company may be called upon to meet at a moment's notice and the shareholder should see that there are set against them, on the credit side, assets of such a nature that they may be rendered quickly available at the values assigned to them. For this purpose, leaseholds, freeholds, and goodwill, which are generally lumped together as if they were all made of the same material, are worthless. To point to the magnificence of a debtor's mansion, and the excellence of his reputation, is not a satisfactory answer to the clamour of mistrustful tradesmen. The mansion, to be sure, is some security, but to sell it to advantage would be to incur difficulties, delays, and sacrifices; and, as for good name, it was made by a whisper and by a whisper it may die.

The Jest's Perfection.—It is natural that the directors of every company should desire to close

the year with a fanfare of trumpets by announcing that the gross profits are enormous. There is nothing more easily done under the prevalent system of drawing a balance sheet. Stock-in-hand is largely overvalued, and every bad and doubtful debt is dragged into profit and loss account. Both items are then set off against a pretended reserve fund. Every shareholder will recall meetings at which the chairman has grandiloquently drawn attention to the splendid increase in gross profits, and has wound up his speech by pointing out that the reason why the proposed dividend is so small is that it has been thought expedient to place the company beyond the remotest danger of a crisis by making a large appropriation to reserve. The fund stands out in bold relief on the debit side of the balance sheet, but it is a matter of inordinate difficulty to trace the overvaluation of assets on the credit side. It will be evident from some of the balance sheets which are subjoined that the shareholders, to whom they were presented, had excellent cause for suspicion. In some cases the assets may have been in existence but the necessary proof was absent, and that in itself was a serious flaw in the documents.

Utopia Unlimited.—Here is a statement of account, issued in 1906, by a company which exists outside the pages of fiction. An eminent firm of auditors have certified that the document "is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs":—

Dr.				£	s.	d.
To Capital Account:—						
37,000 five and a half per cent. Cumulative Preference Shares of £5 each, of which 22,000 have been issued fully paid..	£110,000	0	0			
290,000 Ordinary Shares of £1 each, of which 205,000 have been issued fully paid	205,000	0	0			
5,000 Management Shares of £1 each fully paid	5,000	0	0			
				320,000	0	0
Four and a half per cent. First Mortgage Debenture Stock..	150,000	0	0			
Four per cent. Debenture Stock	250,000	0	0			
				400,000	0	0
General Reserve Fund Account				85,000	0	0
Reserve Account against Properties created by the re-valuation				56,739	18	0
Interest on Debenture Stocks, 31st December, 1905, to 28th February, 1906				2,791	13	4
Redemption of Leaseholds Fund four and a half per cent. Debenture Stock				9,301	1	3
Redemption of Leaseholds Fund four per cent. Debenture Stock				1,420	3	9
Directors' and Debenture Stock Trustees' Remuneration Fund				2,800	0	0
Unclaimed Interest and Dividends				87	6	11
Loans from Bankers				102,250	0	0
Trade Creditors				60,080	12	9
Cash Deposits by Employees, &c.				32,164	12	2
Sundry Creditors				18,165	18	10
Balance of Profit and Loss Account now to be disposed of				39,479	7	2
				£1,130,280	14	2

Cr.				£	s.	d.
By Freehold and Leasehold Properties as per valuation dated 6th June, 1902, including Goodwill and amount spent on new buildings to date				719,663	16	2
Fixtures, Fittings, Utensils, &c.	£80,263	8	4			
Less Depreciation	3,093	13	3			
				77,169	15	4
Household Furniture and Carpets	7,599	4	10			
Less Depreciation	538	0	10			
				7,061	4	0
Horses, Vans, Carts, and Harness	15,600	18	6			
Less Depreciation and Maintenance of Vehicles and Harness	3,122	10	3			
				12,478	8	3
Departmental Utensils and Plant.....				10,483	7	2
£9,218 7 11 Consols representing the four and a half per cent. Debenture Stock Leaseholds Redemption Fund with accrued Interest .....cost				8,967	14	7
£1,287 2 10 Consols representing the four per cent. Debenture Stock Leaseholds Redemption Fund with accrued Interest.....cost				1,170	3	9
Stock in Trade				158,962	7	6
Trade Debtors				100,268	5	1
Sundry Debtors, including Insurances, Rates, Taxes, &c., paid in advance				6,819	16	10
Cash at Bankers and in hand.....				27,235	15	6
				£1,130,280	14	2

Applying the test recommended, the shareholder, who was animated by the sordid desire to examine the security for his money and estimate his prospects of profit, would pick out the items in this way :—

Cash Liabilities.		*Cash Assets.*	
Trade Creditors ...	£60,080	Consols	£8,967
Deposits by Employees	32,164	„	1,170
Sundry Creditors ...	18,165	Trade Debtors... ...	100,268
Loans from Bankers	102,250	Cash in hand	27,235
	£212,659		£137,640

Cash Liabilities	£212,659
Cash Assets	137,640
Excess of Cash Liabilities	£75,019

Found Wanting.—As it was announced that the dividend would absorb £70,573, "leaving £6,387 to carry forward to credit of next account," the absolute deficiency in cash was £145,592. Every one of the cash liabilities here, it must be noted, was of a kind that might lead to immediate calls for payment. Employees had deposited £32,000 and they, with ears to hear every inside rumour, however unfounded, would necessarily withdraw their moneys upon the flimsiest hint of approaching adversity. Creditors and bankers too, are keen men of business, and although they may do their best to be obliging they do not approve of having their money out of hand for any length of time if there is a probability, however remote, of losing it altogether. It may be said that they would show no haste to recover the

amount due to them as long as the debtor's circumstances were manifestly prosperous, but there is always the retort that the best proof of prosperity is the power to meet liabilities. On the other hand, stock-in-trade is a large item, £159,000, but it is not an asset that can be applied to the payment of a debt unless the company goes into liquidation, and then it would not realize more than a fraction of that figure. The reserves stand at £142,000, and against them we find "freehold and leasehold properties"—valued four years before the balance sheet was published—"goodwill and amount spent on buildings," £720,000. Goodwill is to a company what vanity is to an individual; it has no money value; it is "a shade that follows wealth and fame and leaves the wretch to weep." It vanishes the instant downfall is threatened. When the two items which represent investments are set against redemption of leaseholds, it becomes clear that the bankers had every reason to look to their bond. What security they might have had in the freeholds and leaseholds the balance sheet does not show, for there is no apportionment of an amount to goodwill; and a creditor cannot be expected to find consolation in the pious aspirations of a board of directors, who probably hold so many of the management shares, which pay a dividend of £2 5s., that they will get back their capital plus a handsome interest before the arrival of the evil day of storms and reconstructions.

Time — One Year Later. — The consequences of this method of finance may be seen best by the production of the company's balance sheet, issued a year later :—

Dr.			
To Capital Account:—	£	s.	d.
37,000 five and a half per cent. Cumulative Preference Shares of £5 each fully paid....	185,000	0	0
290,000 Ordinary Shares of £1 each, of which 230,000 have been issued fully paid	230,000	0	0
5,000 Management Shares of £1 each fully paid	5,000	0	0
Four and a half per cent. First Mortgage Debenture Stock..£150,000 0 0			
Four per cent. Debenture Stock 250,000 0 0			
	400,000	0	0
General Reserve Fund Account.....	116,068	4	3
Reserved Account against Properties created by the re-valuation	56,739	18	0
Trade Creditors.....	73,089	17	4
Cash Deposits by Employees, &c.....	19,951	9	1
Sundry Creditors	23,760	6	8
Interest on Debenture Stocks, 31st December, 1906, to 19th February, 1907	2,569	5	0
Redemption of Leaseholds Fund four and a half per cent. Debenture Stock.....	10,028	16	8
Redemption of Leaseholds Fund four per cent. Debenture Stock	1,831	2	8
Directors' and Debenture Stock Trustees' Remuneration Fund	3,102	10	0
Unclaimed Interest and Dividends	92	2	5
Balance of Profit and Loss Account now to be disposed of	49,765	13	8
	£1,176,999	5	9

Cr.					
By Freehold and Leasehold Properties as per valuation dated 6th June, 1902, including Goodwill and amount spent on new buildings to date.....				£ 730,082	s. d. 10 11
Fixtures, Fittings, Utensils, &c.	£83,781	11	2		
Less Depreciation.....	3,858	9	4		
				79,923	1 10
Household Furniture and Carpets	7,276	14	11		
Less Depreciation	705	2	5		
				6,570	12 6
Horses, Vans, Carts, and Harness	17,179	2	0		
Less Depreciation and Maintenance of Vehicles and Harness	3,393	15	5		
				13,785	6 7
Departmental Utensils and Plant.....				12,000	11 9
£10,044 15 11 Consols representing the four and half per cent. Debenture Stock Leaseholds Redemption Fund with accrued Interest.....cost				9,695	10 0
£1,753 9 0 Consols representing the four per cent. Debenture Stock Leaseholds Redemption Fund with accrued Interest..cost				1,581	2 8
Stock in Trade				172,708	4 4
Trade Debtors				112,497	10 5
Sundry Debtors, including Insurances, Rates, Taxes, &c., paid in advance				7,563	13 0
Cash at Bankers and in hand.....				30,591	1 9
				£1,176,999	5 9

Unconscionable Bankers.—The capital has been increased by £100,000. The preference capital has been raised from £110,000 to £185,000, and the ordinary capital from £205,000 to £230,000. The reserves have risen by £31,000 and the investments have been increased by £11,000 only. None of this increase of capital has been added to the general reserve, because the directors' report stated that the £31,000 by which this fund was augmented represents premiums received on the issue of new shares. It is thus quite apparent that the whole of the capital was raised to pay off the loan from bankers—£102,000. As might have been anticipated by an intelligent shareholder the bankers became uneasy, and the employees who had deposits in the concern, heard the news; accordingly they drew out of the business £12,000. The directors stated that valuable new premises had been acquired, and if we turn again to the entry "freehold and leasehold properties including goodwill and amount spent on buildings" we find that, although the capital called up was £100,000, only £10,500 was added to this item. The portion of that £10,500 which was invested in these valuable new premises may be conjectured, when it is seen that the freeholds and leaseholds were still set down at the 1902 valuation, and when it is remembered that the directors, with £100,000 more capital and new premises, could scarcely have resisted the temptation of adding no small amount to goodwill. Here is the enhanced value of the credit side of the balance sheet:—

	Increase in Value.
Fixtures	£3,000
Horses and vans	1,300
Plant, etc.	1,500
Investments	1,300
Stock-in-trade	13,746
Trade debtors	12,200
Sundry debtors	700
Cash in hand	3,300
Increased value of assets ...	£37,046

With the exception of freeholds and leaseholds which, it has been shown, have acquired but little additional value, there is nothing to put against cash liabilities but this £37,000, much of which would be worthless in the event of realization. Fixtures, horses, and vans, plant and stock-in-trade have been written up but neither the amount at which they were valued a year ago, nor that at which they now appear, could give them the characteristics of security against liabilities of £117,000. No doubt the shareholder would resent criticism of this kind, and would point with pride to the reserves, but here, as in most cases, these funds have been invested in the business and are not therefore available to meet an unexpected contingency except at great losses on realization and at greater risk to the welfare of the business.

Too Rich to Pay.—The following is a balance sheet which was revised by the directors in order to make a case for reconstruction. It illustrates in an unusually glaring way the curious system of

accounts which has become popular. The italics represent the revised figures which are intended to demonstrate that the preference dividend, for which £8,375 was needed, could not be paid :—

Dr. 30th Sept., 1905.							Cr. 30th Sept., 1905.					
£	s.	d.		£	s.	d.	£	s.	d.		£	s. d.
			To Capital Authorised and Subscribed, viz.:—				49,165	7	11	By Freehold Land and Buildings *Ditto, as per Mr. ——— Valuation*	*29,532*	*0 0*
			33,500 Five per cent. Cum. Pref. Shares				27,367	4	4	,, Plant, Machinery and Tools *Ditto, as per Messrs. ——— and Sons' Valuation*	*24,987*	*6 8*
167,500	0	0	of £5 each ..				692	4	7	,, Office Furniture, Fixtures and Fittings *Ditto, as per Messrs. ——— and Sons' Valuation*	*720*	*16 11*
167,500	0	0	33,500 Ordinary Shares of £5 each ..				39,518	4	6	,, Stock on Hand *Ditto, as per Mr. ———'s Valuation*	*39,518*	*4 6*
335,000	0	0					21,669	14	7	,, Debtors, *less* Reserves for Discount and Bad Debts.. *Estimated by Directors to produce*	*21,669*	*14 7*
			33,500 Five per cent. Cum. Pref. Shares of £3 10s. each	*£117,250*	*0*	*0*	6,289	6	9	,, Cash and Bills in Hand and at Bankers *Estimated by Directors to produce*	*6,289*	*6 9*
			67,000 Ordinary Shares of £1 10s. each	*100,500*	*0*	*0*	4,184	15	10	,, Foreign Acceptances *Estimated by Directors to be worth*	*2,734*	*6 8*
						217,750 0 0	19,873	6	2	,, Investments *Estimated by Directors to be worth*	*17,073*	*6 2*
2,063	18	5	,, Creditors			*2,063 18 5*	2,261	8	6	,, Outlay on an invention	*2,261*	*8 6*
258	0	7	,, Suspense Account for Interest paid in advance			*258 0 7*	658	2	0	,, Motor Car Installation	*658*	*2 0*
50	13	7	,, Unclaimed Dividends ..			*50 13 7*	733	10	1	,, Re-construction Scheme Expenses	*733*	*10 1*
5,273	18	11	,, Revenue Account			*5,273 18 11*	170,233	6	3	,, Goodwill, Patents, Licences and Trade Marks, taken as not exceeding	*79,218*	*8 8*
£342,646	11	6				*£225,396 11 6*	£342,646	11	6		*£225,396*	*11 6*

Here it will be seen that, on the new valuation, the cash liabilties are £2,063. Against these there are, according to the statement itself, cash assets to the value of £47,776. Nevertheless, with a cash balance of £45,000, after settling with creditors, the directors declare that they cannot pay the preference dividend of £8,375. It is obvious that the balance sheet conceals the truth about the company's predicament.

A Galloping Consumption.—But there is another lesson to be learned from a case of this kind. During the whole career of this company freehold land and buildings had probably been appearing upon the balance sheet at a figure which had to be written down by £20,000 the moment the directors obtain the valuation of a person who was presumably an expert. Goodwill, patents, licences and trade marks were said to be worth £170,233 on September 30th, 1905, but, in the following February, it dawned upon the board that the real value of these assets was only £79,218. If there was any justification for entering these items upon the balance sheet in September at £170,233—and it must be assumed that the auditors accepted this valuation on that date—it would be interesting to know how they underwent a depreciation in value of £91,000 in six months. Goodwill might be eliminated, because even an actual loss of profits in half a year would not have detracted so greatly from the average upon which

it is calculated. Again, if patents, licences and trade marks were expiring, that was known in many a previous half-year, and provision should have been made for loss through the wasting of an important asset. When £113,000 is written off at last for depreciation, with a view to reconstruction, the shareholder might well ask what would be the value, if they came to be put under the hammer, of freehold land and leaseholds, which upon reappraisement were found to have declined in value by £20,000. This figure may be taken as the estimated value of the freeholds and the leaseholds to the company which owns them as accessories to the business carried on, but there could be no guarantee that they would realize the same amount if it became incumbent ultimately to sell them for the benefit of the shareholders.

The subjoined balance sheet also is of interest. There are two reserve funds and not a farthing is invested :—

Dr. *Liabilities.*			£ s. d.
To SHARE CAPITAL—			
25,000 Shares of £20 each....			500,000 0 0
,, DEBENTURE STOCK—			
First Debenture Stock	£200,000 0 0		
Second ,, ...	150,000 0 0		
			350,000 0 0
Bills Payable			1,810 16 7
Sundry Creditors			4,006 8 4
Debenture Interest Warrants outstanding			5,801 6 10
Reserve Fund			60,000 0 0
Special Reserve Fund			15,000 0 0
Depreciation Fund for Renewal of Buildings, Plant, &c.			
As per last Account	22,934 15 11		
Deduct Expended during the year in reconstructing Reservoir	7,912 10 6		
			15,022 5 5
Balance of Profit and Loss Account.....			74,834 7 10
			£1,026,475 5 0

Cr. *Assets.*			£ s. d.
By Purchase Price of the undertaking, as per last Account			700,000 0 0
Additional Capital Expenditure to 31st December, 1905	£220,714 6 11		
Expended during 1906—			
Extension of City Mains ..	3,264 11 8		
New Buildings	427 8 11		
			224,406 7 6
			924,406 7 6
Fittings and Stores—			
Stock of Fittings	9,099 19 9		
Materials and Stores	11,691 17 2		
Meters	23,781 4 7		
			44,573 1 6
Freehold Premises at ———	9,210 5 3		
Furniture at ———	848 3 1		
			10,058 8 4
Sundry Debtors for Water Rents, Meter Rents, Fittings, &c.—			
Private Services	10,073 6 0		
Government Accounts	706 1 8		
Sundry Debtors	1,047 18 3		
			11,827 5 11
Bills Receivable in hand and in Transit.....	21,000 0 0		
Deposit (London)	7,500 0 0		
Cash at Bankers, and in hand, at Monte Video and Head Office	7,110 1 9		
			35,610 1 9
			£1,026,475 5 0

The next statement of accounts will appear, at first sight, to satisfy the test proposed. The cash assets are £81,000 and the liabilities are £91,000. Six thousand pounds is to be paid in dividends :—

Dr. *Capital and Liabilities.*	£	s.	d.	£	s.	d.
To Capital Authorised—						
24,000 Preference Shares at £5 each	120,000	0	0			
36,000 Ordinary Shares at £5 each	180,000	0	0			
	£300,000	0	0			
,, Capital Issued—						
18,117 Preference Shares at £5 each	90,585	0	0			
21,493 Ordinary Shares at £5 each	107,465	0	0			
				198,050	0	0
Sundry Creditors				26,616	8	3
Loan from Bankers				64,176	2	2
,, Profit and Loss Account—						
Profit for the year	15,095	3	7			
Less balance from 1905	7,316	0	1			
				7,779	3	6
				£296,621	13	11

Cr. *Property and Assets.*	£	s.	d.	£	s.	d.
By Land				9,715	3	9
Old Side Works, Buildings and Machinery, as per last Account	32,760	17	0			
Less Depreciation	1,347	0	0			
	31,413	17	0			
Add Additions during the year	159	15	2			
				31,573	12	2
New Side Works, Buildings and Machinery, as per Messrs. ———'s fresh valuation, including all new machinery and buildings and £7,115 16s. 8d. expenditure on new plant in the past year				108,626	0	0
Loose Tools				7,523	12	2
Stores and Spares, &c.				3,901	1	3
Stock, as per Messrs. ———'s valuation				54,232	7	0
Sundry Debtors, after making allowance for Discounts				38,270	5	5
Cash at Bankers, on Current Account, and in hand				42,779	12	2
				£296,621	13	11

APPROPRIATION ACCOUNT.

Dr.	£	s.	d.
To Balance from 1905	7,316	0	1
Preference Dividend, half year 31st December, 1905	2,246	11	4
Preference Dividend, half year 30th June, 1906	2,264	12	6
Preference Dividend, half year 31st December, 1906	2,264	12	6
Balance carried forward	1,003	7	2
	£15,095	3	7

Cr.	£	s.	d.
By Profit for year ended 31st December, 1906	15,095	3	7
	£15,095	3	7

The suspicious feature of the balance sheet, however, is the attitude of the company towards its bankers. The loan from bankers is £64,176 and the cash at bankers is £42,779. A man of business would ask at once, Why not pay off some of the loan and save interest?

The Halo of Goodwill.—The following balance sheet is printed mainly to draw attention to the fact that the directors estimate the company's goodwill at a fifth of the capital. It was no doubt a matter for rejoicing to the shareholders that £40,000 of their money was expended in acquiring a good name. It is to be hoped, however, that none of them asked himself how much money he was about to make out of this investment in a commercial aureole. Calculated on the basis of so many years purchase of the profits of the company, the goodwill might be an admirable guide to an intending buyer, but considered as an asset to be converted into cash in order to meet liabilities which must be liquidated while the company is a going concern its value is nothing:— ?

Dr.

Liabilities.

	£	s.	d.	£	s.	d.
Share Capital—						
10,000 Preference Shares of £10 each, fully paid	100,000	0	0			
10,000 Ordinary Shares of £10 each, fully paid	100,000	0	0			
				200,000	0	0
Creditors on Open Account at Head Office and Branches				10,054	5	9
Cash due to Banks—						
On Overdraft	84	14	10			
Secured over —— Property	7,161	8	0			
				7,246	2	10
Sundry Credit Balances				2,156	12	10
Special Reserve Fund as at 1st January, 1906				1,401	0	10
Profit and Loss Account—						
Balance at Credit				2,467	11	5
				£223,325	13	8

Cr.

Assets.

	£	s.	d.
Ground, Buildings, Machinery, Plant, &c., at Head Office and Branches	54,631	6	0
NOTE.—The title-deeds of the —— property are held by the National Provincial Bank as security *per contra*.			
Goodwill	39,000	0	0
Book Debts at Head Office and Branches	61,972	8	0
Cash and Bills on hand	591	2	2
Stock in Trade and Work in Progress at Head Offices and Branches	65,273	8	9
Sundry Shares and Assets	1,857	8	9
	£223,325	13	8

An Oasis in the Desert.—The following is an example of a healthy balance sheet, though it will be seen that here also part of the reserve fund is invested in the business :—

Dr.	£	s.	d.	£	s.	d.
To Creditors :—						
Sundry Creditors	112,732	11	10			
Dividends unclaimed	603	15	10			
Reserve for estimated further Expenditure on orders in voiced, fall in value of Investments, &c.	107,000	0	0			
				220,336	7	8
,, Capital :—						
Authorized and Issued.						
100,000-6 per Cent. Cumulative Preference Shares of £1 each, fully paid ..	100,000	0	0			
830,000—Ordinary Shares of £1 each, fully paid ..	830,000	0	0			
				930,000	0	0
930,000 Shares						
Reserve Fund				200,000	0	0
Dividend Equalization Fund				125,000	0	0
Profit and Loss Account :—						
Balance as per last Account ..	250,966	14	7			
Deduct						
Dividends to 31st December, 1905, declared 19th April, 1906.						
On Preference Shares £3,000	0	0				

Cr.	£	s.	d.
By Cash at Bankers on Deposit and Current Accounts, and in Hand London, Glasgow, and Branches	87,100	15	10
Bank of England Loan and Current Accounts	20,590	16	2
Investments at Cost	315,118	13	11
Mortgage	9,545	3	9
Bills Receivable	21,927	18	5
Debtors.....	638,513	8	8
Expenditure on Orders not Invoiced	11,557	16	5
Stock of Merchandise, and Work in progress	236,322	19	4
Freehold Land and Leasehold Property, Plant, Buildings, Patents, and Shares in Associated Companies, including additions for the year ending 31st December, 1906 ..	383,153	19	8

On Ordinary Shares including Bonus	96,000	0	0					
Reserve Fund, amount transferred	100,000	0	0					
Dividend equalization Fund amount transferred	20,000	0	0					
				219,000	0	0		
				£31,966	14	7		
Profit for the year ending 31st December, 1906				285,928	9	11		
				£317,895	4	6		
Deduct								
Interim Dividends paid 8th October, 1906.								
On Preference Shares	£3,000	0	0					
On Ordinary Shares	66,400	0	0					
				69,400	0	0		
							248,495	4 6
							£1,723,831	12 2

£1,723,831 12 2

The reserve fund of £200,000 and the dividend equalization fund of £125,000 are balanced by investments at cost—£315,000 and mortgage £10,000. Cash at bankers is £107,600; debtors are £638,500 and creditors are only £220,000.

CHAPTER V.

DIVIDENDS AND CAPITAL.

Fixed and Circulating Capital—Judicial and economic distinctions—Lee v. *Neuchâtel Asphalte Company—Reserve for wasting assets—Loss to fixed capital—The aim of the Statute Law—Sanction of the Court necessary to reduce capital—Dovey* v. *Cory—Altered views of the Courts—Profits for the year—Complete and continuous ventures.*

A Faith Outworn.—The question how the profits of a company should be calculated has never been answered by the Courts without ambiguity. Judges made it the custom for many years to base their decisions upon the definitions of economists, and this made necessary at times a good deal of difficult reasoning if justice was to be done between the litigants. In determining what were profits the old distinction between fixed and circulating capital had always been drawn—a distinction which owes its origin to Adam Smith, who defined fixed capital as that which affords a revenue or profit without changing masters, and circulating capital as that which affords a profit only by changing masters. These definitions, expounded by economists of recent years, are to be traced in all the judicial decisions which were directed towards the solution

of the problem of company profits down to 1901. In that year the case of Dovey *v.* Cory (T.L.R. xvii., 734), came before the House of Lords, and Halsbury, L.C., pointed out that the distinction between fixed and circulating capital, although appropriate enough in an abstract treatise like the "Wealth of Nations," might be quite inappropriate with reference to a concrete case. The Court was not called upon to decide what constituted a payment of dividends out of capital, but there are passages in the judgments delivered which may be taken to indicate an altered attitude towards old-time cases and an outworn economic faith. These passages will be referred to later. Meanwhile, as the matter is of vital importance to the shareholder it is best that he may have the opportunity of seeing how it has been regarded by the highest authorities on law, economics and accountancy.

A Land Question.—The distinction between fixed and floating or circulating capital which has been observed by the Courts is conspicuous in the following cases. A railway company, the rolling stock and real property of which were obviously fixed capital, failed one year to make sufficient profits to pay a dividend. The land owned by the company, however, had increased considerably in value and it was resolved by the directors to treat this increase in value as profit out of which to pay a dividend. This was disallowed by James, V.-C., on the ground that

the payment of a dividend out of the new value given to the land would be a distribution of capital, not of profits. (Salisbury *v.* The Metropolitan Railway Co., 22 L.T. 840). Then came a case in which land was held to be circulating capital, because a part of the company's business was the purchase and the sale of land, or, in other words, because the land was part of the stock-in-trade of the concern. It happened that as the revenue from the rents of the lands held by this company was not large enough to justify the payment of a dividend, the board decided to distribute among the shareholders an amount representing the increase in the value of its property. Mr. Justice Chitty, observing the economic distinction, declared that while the land of a railway company was part of a fixed undertaking, the land of an investment company was circulating capital, which in the very nature of things was intended to change hands, and that, in these circumstances, it was legitimate to pay a dividend, provided that the valuation of the capital asset was sound. This decision can hardly stand, for while it shows well the distinction between the two kinds of capital, it is clear that the principle of paying dividends out of a revaluation of stock-in-trade cannot be justified either in law or in finance. The cases of Davison *v.* Gillies (16 Ch. 345) and Lee *v.* The Neuchatel Asphalte Company [(1889) 41 Ch. D. 1) provide an instructive comparison. In the former Sir George Jessel held that a tramway company was not entitled to pay a dividend out of

gross receipts before making good the wear and tear of its rolling stock; and in the latter Lord Justice Lindley said, that with regard to mines and quarries, "every ton of stuff you get out of that which you have bought with your capital may, from one point of view be considered as embodying and containing a small portion of your capital," and that it was obvious with respect to such property, "if you sell and divide the proceeds, you divide some portion of that which you have spent your capital in acquiring." "It may be represented," he added, "that that is a return of capital. All I can say is, if that is a return of capital, it appears to me not to be such a return of capital as is prohibited by law." He went on to point out that if a company is formed to acquire and work a property of a wasting nature, for example, a mine, a quarry, or a patent, the capital expended in acquiring the property may be regarded as sunk and gone, and that there is nothing whatever in the Act of 1862, or indeed in subsequent Acts, to prevent an excess of money, obtained by working the property over the cost of working it from being distributed among the shareholders, even though some portion of the property is sold and the capital, in some sense, is thereby diminished.

Loss of Fixed Capital.—Five years later Lord Lindley again insisted upon the same distinction in Verner *v.* The General Commercial Trust (1894, 2 Ch. 239). Here he laid down that "if the income,

in any year, arises from the consumption in that year of what may be called circulating capital, the division of such income as dividend, without replacing the capital consumed in producing it, will be a payment of dividend out of capital. Perhaps the shortest way of expressing the distinction which I am endeavouring to explain," he said, "is to state that fixed capital may be sunk and lost and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without first deducting the capital which forms part of it will be entirely contrary to law. . . . . "A dividend presupposes a profit in some shape, and to divide, as dividend, the receipts, say for a year, without deducting the expenses incurred in that year in producing the receipts, would be as unjustifiable in point of law as it would be reckless and blameworthy in the eyes of business men."

In the Honest Forties.—These words are reminiscent of a strong pronouncement in 1849 by Lord Chancellor Campbell, who argued that the declaration of a dividend by the directors of a company was tantamount to a public declaration that the company had earned profits from which that dividend was to be paid, and that if the dividend had to be paid out of the capital of the firm the board was guilty of a fraud which rendered the directors liable to prosecu-

tion for conspiracy. (Barnes *v.* Pennell, 2 H.L.C. 535).

It was held in Bosanquet *v.* The St. John del Rey Mining Company (103 L.T. 316) that a dividend might be paid before a loss to capital had been recouped. The company was formed for the purpose of mining gold in Brazil and, after it had been paying good dividends for a number of years, a part of the mining works collapsed and prevented further operations. The company was reconstructed twice in order to raise the money necessary to remove the obstruction, the capital being increased by the issue of shares and debentures. The mine was then reopened and new machinery was provided. From the time of issuing the debentures to the time of reopening the mine a considerable sum was paid out of capital by way of interest on the debentures, but when the mine was reopened that interest was paid from income. Ultimately it was decided by the board to create a sinking fund out of profits with which to make good the amount already paid out of capital for debenture interest. At the same time it was agreed to distribute a small part of the profits as dividend. A holder of shares and debentures in the company thereupon applied for an injunction to restrain the directors from appropriating any part of the profits for payment of a dividend until the sum taken from capital to pay debenture interest had been replaced. The Court decided, however, that the company was not bound to apply profits to

the restoration of the amount paid out of capital in previous years, apparently on the grounds that the one year's trading alone was to be taken into consideration.

Lord Justice Romer followed the decision of Lee *v.* The Neuchatel Asphalte Co. in Bolton *v.* The Natal Land and Colonization Co. [(1892) 2 Ch. 124) declaring that it was not correct, in estimating the profits of a year, to take into account the increase or decrease in the value of the capital assets of the company. These cases, together with that of Wilmer *v.* McNamara & Co. ([1895], 2 Ch. 245), where a revaluation of property showed a loss to capital, are now very doubtful law.

An Ingenious Proposal. — The legislature has always declined to countenance the payment of dividends out of capital. By the Companies Acts it has made a contract as regards the status of limited companies which is framed to safeguard not only the interests of the shareholders, but those of the public generally. The requirements of the law have been said to be merely negative, that dividends shall not be paid out of capital, and that the balance to the credit of profit and loss account does not automatically become part of the capital assets, because the value of the actual capital assets has depreciated to an amount equal to or exceeding such balance. If this were a correct view, and if it were permissible for a company to take the balance to the

credit of the profit and loss account and, after holding it as a reserve or surplus account for a year, distribute it as dividends, the whole intention of the legislature against the reduction of capital without the consent of the Court would be frustrated. The balance to the credit of profit and loss does not, it is true, automatically fill the hole that has been made in capital by depreciation, but this can be no answer to the decrees of the legislature that the company must see that no diminution of capital takes place without the sanction of the Registrar of Public Companies. People put their money into a trading concern to obtain an income, and although the stoppage of dividends for the purpose of making good a loss of capital might dangerously depreciate the value of the shares they are bound, it is submitted, to face the contingency.

On the other hand, if it were permissible to continue the payment of dividends without the replacement of capital assets that had been lost, it would be possible for promoters to float a company and then, by paying large dividends without the creation of a reserve, to inflate the value of the shares on the market to such an extent that members of the public would be tempted to acquire an interest in a concern which in reality had not the means to carry on the enterprise for which it was formed. If Lee *v.* The Neuchatel Asphalte Company were held to be good law, it would even be possible for the shareholders themselves, to conspire with the directors in

order to distribute capital invested in a wasting property, without the creation of a reserve, and thus to dispose of their interests in the concern at a profit by sending up the price of the shares to a figure which was wholly unjustified by the financial position of the company.

How to Work a Mine.—Take a case analagous to Lee *v.* The Neuchatel Asphalte Company. A syndicate is formed to acquire the mining rights over an area of 1,000 acres. It is found, after purchase, that the property contains only one small vein of auriferous ore. The directors and a few of the largest shareholders becoming aware of this, decide to work the vein for all it was worth and to distribute the excess of receipts over expenditure, without creating a reserve for depreciation or taking any steps to preserve the financial position of the company. Good dividends are paid for two or three years; the market value of the shares goes up; the members of the company naturally conceal the truth that the auriferous vein is all but exhausted; that there is no prospect of striking another and that, if there were a prospect, there would be no money with which to begin operations. Meanwhile shareholders and the directors, who have had a considerable part of their capital returned in dividends resolve to dispose of their shares at the inflated price, and a new set of shareholders is induced to sink money in a worthless property. Beyond this, the large dividends and the

spurious value given to the shares have led those who have had dealings with the company to believe that they have been doing business with a concern whose estate was yearly increasing in value, and yearly offering improved justification for the trust that they had given. Nor does it avail to draw distinctions between capital and revenue accounts for this purpose, because the Memorandum of Association is often so composed that the company it governs shall have power to undertake a secondary branch of business in which fixed capital may be silently converted into circulating capital with a view to distribution. But doubts have been expressed of the soundness of Lee *v.* The Neuchatel Asphalte Company, which will be dealt with in another section.

The Companies Acts.—Nothing in the statute law is clearer than the injunction that companies cannot of their own free will pay away the capital which they have obtained from the public, reckless of the ultimate fate of the undertakings for which they were formed. The following sections of the Companies Act indicate the intentions of Parliament in this respect:—

The Companies Act, 1867, section 9: Any company limited by shares may, by special resolution, so far modify the conditions contained in its memorandum of association, if authorised so to do by its regulations as originally framed, or as altered by special resolution, as to reduce its capital, but *no such*

resolution for reducing the capital of company shall come into operation until an order of the Court is registered by the Registrar of Joint Stock Companies.

Table A, Companies Act, 1862, section 73: No dividends shall be payable except out of the profits arising from the business of the company.

The Companies Act, 1877, section 3: The word "capital" as used in the Companies Act, 1867, shall include paid-up capital; and the power to reduce capital conferred by that Act shall include a power to cancel any lost capital, or any capital unrepresented by available assets, or to pay off any capital, which may be in excess of the wants of the company; and paid-up capital may be reduced, either with or without extinguishing or reducing the liability (if any) remaining on the shares of the company, and to the extent to which such liability is not extinguished or reduced, it shall be deemed to be preserved, notwithstanding anything contained in the Companies Act, 1867.

Section 4: The provisions of the Companies Act, 1867, as amended by this Act shall apply to any company reducing its capital in pursuance of this Act and of the Companies Act, 1867, as amended by this Act.

Provided that, where the reduction of the capital of a company does not involve either the diminution of any liability in respect of unpaid capital, or the payment to any shareholder of any paid-up capital.

(1) The creditors of the Company shall not,

unless the Court otherwise direct, be entitled to object, or required to consent to the reduction, and—

(2) It shall not be necessary, before the presentation of the petition for confirming the reduction to add, and the Court may if it thinks expedient so to do, dispense altogether with the addition of the words "and reduced" as mentioned in the Companies Act, 1867.

In any case that the Court thinks fit so to do, it may require the company to publish in such manner as it thinks fit the reasons for the reduction of its capital, or such other information in regard to the reduction of its capital as the Court may think expedient with a view to give proper information to the public in relation to the reduction of its capital by a company, and, if the Court thinks fit, the causes which led to such reduction.

The minute required to be registered in the case of reduction of capital shall show, in addition to the other particulars required by law, the amount (if any) at the date of the registration of the minute proposed to be deemed to have been paid up on each share.

(By section 15 of the Companies Act, 1867, the minute must receive the approval of the Court.)

Section 5: Any company limited by shares may so far modify the conditions contained in its memorandum of association, if authorised so to do by the

regulations as originally framed, or as altered by special resolution, as to reduce its capital by cancelling any shares which, at the date of the passing of such resolution, have not been taken or agreed to be taken by any person; and the provisions of the Companies Act, 1867, shall not apply to any reduction of capital made in pursuance of this section.

The Companies Act, 1880, section 3: When any company has accumulated a sum of undivided profits, which, with the consent of the shareholders, may be distributed among the shareholders in the form of a dividend or bonus, it shall be lawful for the company, by special resolution, to return the same, or any part thereof, to the shareholders in reduction of the paid-up capital of the company, the unpaid capital being thereby increased by a similar amount. The power vested in the directors of making calls upon the shareholders in respect of moneys unpaid upon their shares shall extend to the amount of the unpaid capital as augmented by such reduction.

Section 4: *No such resolution as aforesaid shall take effect until a memorandum showing the particulars required by law in the case of a reduction of capital by order of the Court shall have been produced to be registered by the Registrar of Joint Stock Companies.*

The Companies Act, 1907, section 9:—

Payment of Interest out of Capital.

Where any shares of a company are issued for the purpose of raising money to defray the expenses of the construction of any works or buildings or the

provision of any plant which cannot be made profitable for a lengthened period, the company may pay interest on so much of such share capital as is for the time being paid up for the period and subject to the conditions and restrictions in this section mentioned, and may charge the same to capital as part of the cost of construction of the work; building, or plant:

Provided that—

(1) No such payment shall be made unless the same is authorised by the company's articles of association or by special resolution of the company:

(2) No such payment, whether authorised by the articles of association or by special resolution, shall be made without the previous sanction of the Board of Trade:

(3) Before sanctioning any such payment, the Board of Trade may, at the expense of the company, appoint a person to inquire and report to them as to the circumstances of the case, and may, before making the appointment, require the company to give security for payment of the costs of the inquiry.

(4) The payment shall be made only for such period as may be determined by the Board of Trade: and such period shall in no case extend beyond the close of the half year next after the half year during

which the works or buildings have been actually completed or the plant provided :

(5) The rate of interest shall in no case exceed four per cent. per annum or such lower rate as may for the time being be prescribed by Order in Council :

(6) The payment of such interest shall not operate as a reduction of the amount paid up on the shares in respect of which it is paid :

(7) The accounts of the company shall show the capital on which, and the rate at which, interest has been paid out of capital during the period to which the accounts relate.

Section 39.—(1) A company may by special resolution confirmed by an order of the court modify the conditions contained in its memorandum of association so as to re-organise its capital, whether by the consolidation of shares of different classes, or by the division of its shares into shares of different classes : Provided always that no preference or special privilege attached to or belonging to any class of shares shall be interfered with except by a resolution passed by a majority of shareholders of that class, representing three-fourths of the capital of the class and confirmed in the same manner as a special resolution of company is required to be confirmed, and every resolution so passed shall bind all shareholders of such class.

(2) Where an order is made under this section an office copy thereof shall be filed with the registrar within seven days after the making of the order, and the resolution shall not take effect until such a copy has been so filed.

From these sections it will be seen that the whole course of company legislation is directed against acts which may diminish the value of the company's assets in such a way that third parties may be deceived in their transactions with the company. Just as the legislature, by its limited liability Acts has given the shareholder a guarantee that he shall not be responsible to creditors beyond a defined amount, so it has decreed that that amount shall nevertheless be available, as far as possible, to meet liabilities incurred by the company in the course of its legitimate operations. Each shareholder is protected against the creditors of the company to the extent of the contributive liability of all the rest, and, in consideration of this, the creditors must be protected against a secret reduction in the value of their limited security. (See McDougall *v.* The Jersey Imperial Hotel Company, 2 H. & M., 528, 12 W.R. 1142).

Judicial Secessions. — Lord Davey, delivering judgment in Dovey *v.* Cory (*infra*), referred to the opinions of the Judges in the lower Court, saying: "They seem to have thought that a joint stock company, incorporated under the Companies Acts, may write off to capital losses incurred in previous

years, and may, in any subsequent year, if the receipts for that year exceed the outgoings, pay dividends out of such excess without making up the capital account. If this proposition be well-founded it appears to me that a company, whose capital is not represented by available assets, need never trouble itself to reduce its capital with the leave of the Court and subject to the other conditions imposed by the Act of 1877, in order to enable itself to pay dividends out of current receipts."

Mr. Justice Farwell determined to accept this view in Bond *v.* The Barrow Hematite Steel Company, Limited (T.L.R. xviii. 249), and, in doing so, he was driven to a remarkable extension of the economic definition of circulating capital in order to reconcile his decision with the statutes. Of course, Lord Lindley's pronouncement in Verner *v.* The General Commercial Investment Trust (*infra*) was quoted and the reply was: "I do not understand his lordship to be laying down a general and universal rule that in every company fixed capital may be sunk and lost, but that there are companies in which that may be the case. All the authorities, however, agree, I think, that circulating capital must be kept up. Now, in the present case, the £200,000 realized loss arises by the surrender of the leases of certain mines, by the pulling down of certain furnaces, and on the sale of certain cottages. The company is a smelting company on a very large scale and, for the convenience of its works and by way of economy, they

acquired the leases of the surrendered mines in order to supply themselves with their own ore. . . . . The mines were drowned out, and the cost of pumping them out was prohibitive. The company, therefore surrendered the leases, pulled down the blast furnaces and sold the cottages connected therewith. . . . . The defendants' witnesses all agree that in a company of this nature these items ought to come into account before any profit can be said to be earned, and my own opinion coincides with theirs, inasmuch as I think that the money invested in those items is properly regarded in this country as circulating capital.

Economists Dethroned.—"Suppose the company had bought enormous stocks of ore, sufficient to last ten years, it could hardly be said that the true value of so much of this as remained from time to time ought not to be brought into the balance sheet, and I can see no difference, for the purpose of the account, between ore *in situ* and ore so bought in advance. The blast furnaces and cottages are mere accessories to the ore, and resemble a building for burning the stores bought in advance, already mentioned." This decision, read with that in Dovey *v.* Cory appears to sweep away, once and for all, the distinction between fixed and circulating capital as a touchstone for company finance. If that from which circulating capital may be obtained is in itself circulating capital, then must the factory come within the

same category as the mine. If ore *in situ* is the same as ore bought in advance, the raw material in a store is the same thing as the finished product. In both cases the transformation is wrought by labour and skill. Again, if such "accessories" as cottages and furnaces to circulating capital in the form of a mine are themselves to become floating assets, there is no ground for excluding from that class the leasehold or the freehold premises which are the necessary accessories to the disposal of the stock-in-trade. Therefore, if it is compulsory to make good a loss to capital through the demolition of furnaces and the sale of cottages, it must be equally binding upon a company to maintain other forms of what was once known as fixed capital at a figure approximating to its original value.

The view of the question which must appeal most strongly to the man of business is that of Mr. Justice Chitty in Lubbock *v.* The British Bank of South America ([1892], 2 Ch. 128) as indicated in his example of the financial principle of profit and loss. "A man's business," he said, "is to make boots and shoes. He has £10,000 which he takes into the business as capital. He makes boots and shoes and spends the whole £10,000 in doing it, and he sells and gets back from his customers a certain sum on the sale. He compares then—assuming he has sold all—what he has got back with his expenditure in producing the boots and shoes and putting them on the market and he finds that he has £10,000, his

capital intact, and the rest—if there is a rest remaining in his hands—is profit. On the other hand, if he has only £9,000, his capital is not intact and he has lost. It is exactly the same principle that has to be applied to a trading company under the Companies Acts."

The loss to capital must be made good or it must be cancelled, and cancellation can only be done with the sanction of the Court. In Bannatyne *v.* The Direct Spanish Cable Company (34 Ch. D. 287) the company lost capital by the destruction of a cable, and having earned a profit on its remaining cables was anxious to pay a dividend without replacing the lost capital. Upon the advice of Sir Horace (now Lord) Davey an application was made to the Court for the cancellation of the capital lost, and the argument was never advanced that it would have been legal to pay a dividend before disposing of the loss, either by recoupment or by cancellation.

Sufficient unto the Year.—It is contended that, as the regulations of most companies provide that the accounts shall be balanced annually, the operations of one year must be kept apart from those of another when the profit and loss account is being made up. For instance, if a company with a capital of £100,000 were to lose £10,000 in 1907, it must be held to have begun trading afresh, as it were, in 1908 with a capital of £90,000, and the excess of receipts over expenditure may be divided as profit

among the shareholders, without replacing the whole, or any part of the £10,000 capital that had disappeared. Profits, it is said, are the excess of returns over advances, and the advances of the year include not £100,000 but £90,000. If this principle is to be maintained by the Courts, there is nothing to prevent a company's distributing an accretion to capital which might be due merely to causes over which the company had no control and which were purely transitory in their operation. These distinctions and definitions have tended to lead the Courts to extremes which neither the public nor the Legislature ever contemplated. It has always been a doctrine of English law that the intentions of contracting parties shall have equitable consideration; and it is certain, in spite of the decision in Lee *v.* The Neuchatel Asphalte Company, that future judgments will have regard to the fact that those who have any dealings with a public company upon the understanding that the paid-up capital is undiminished by the payment of dividends, will be protected against the secret manipulation of the company's finances which would deprive them of all security for their credit. The shareholders, too, are in need of similar protection, because in all but the rarest instances, they continue to hold their shares in the company under the belief that the capital, be it fixed or circulating, still remains unweakened in its power to earn profits.

Balm of Hurt Minds.—It is argued that, while an increase or a decrease in the market value of fixed capital cannot be taken into account when estimating profits of the year, an increase or a decrease in the market value of circulating capital may enter into the profit and loss account, provided that the increase or the decrease is not due to purely temporary fluctuations in prices. This is the contention of those who advocate the keeping distinct of each year's accounts. But if it is improper to drag into the balance sheet a loss to fixed capital in a previous year, it should be equally improper to make use of an estimated increase in circulating capital which could not be realized until a succeeding year. If the trading of the year before is to be excluded, that of the year after cannot be included whether the accounts have reference to fixed or to circulating capital. If an adverse event that is past is to be ignored there is no reason why a favourable contingency should be recognized. The loss of last year is a certainty; the profit of next year is at best a probability, incalculable in degree.

"Profits for the year," said Sir George Jessel in Dent *v.* The London Tramway Company ([1881] 16 Ch. Div. 344), "mean the surplus in receipts, after paying expenses and restoring the capital to the condition it was in on the 1st of January in that year." Here it was represented that the capital in question, the railway stock, &c., was to be restored to the condition it was in when the line was opened.

That may be correct; but if depreciations had been deducted to an adequate extent each year, there would have have been no need to make the distinction. The mistake lies in narrowing the scope of the balance sheet. No doubt, it is intended primarily to show the company's position and its profit and loss at the end of a year, but, as it is decreed by law that it shall be certified by auditors to give a true and correct view of the affairs of the company, it is impossible to argue that a loss to capital must be concealed by accountancy in the numerous items that are usually set forth. The balance sheet is not supposed to show the transactions of a company throughout a period of twelve months, but the position of the company at a fixed date. If it is justifiable to ignore a loss to capital, it should be equally justifiable to neglect other liabilities contracted in a previous year, and it would be necessary to write off debts twelve months outstanding. It is absurd therefore, to say that a company is entitled to turn its back upon the results of recent adversity and to hoodwink the public to a loss which, if it does not destroy, at all events impairs its working efficiency for years to come. No jeweller, for example, would enter upon a more expensive style of living because the market price of silver had risen and was likely to remain high for a year or two. The silver that he has on stock is his circulating capital; he is a seller and he will dispose of it at the best price he can get; but before he has

realized his stock and has effected an actual turnover, he declines to distribute profits, as yet unearned by adding to his personal expenses. On the other hand, although he is not a seller of his shop, which is fixed capital, it would be considered folly were he to ignore its altering value. If the neighbourhood were declining as a trading centre, he would make a reserve fund lest at a future day it might be to the interest of his business that he should acquire premises elsewhere. Again, if the value of the shop were increasing, he might consider the increase in value as a kind of reserve fund, but it is certain that he would not embark upon a career of luxury because freehold values were rising. To adapt an excellent argument of Adam Smith's, what is prudent in the individual can scarcely be imprudent in a company, composed of individuals. Yet another distinction has been made with considerable plausibility. It is said that dividends must necessarily be paid out of capital where the shareholders invested their money in the purchase of a patent or a concession which, in its nature, could not exist beyond a fixed number of years. Here it is clear that, so far as the shareholders are concerned, the institution of a reserve against the expiration of the patent, would be no more than the postponement of a payment to the close of the venture; and it is asked why the distribution of the money should be delayed. As a rule there are not many companies which, on their own representations at all events, are formed for

the sole purpose of working a solitary patent; but assuming that there are some honest enough to admit that their foundations are of a crumbling nature, the statutes must apply to them as well as to their more substantial fellows. If the shareholders in such ephemeral companies themselves are frequently led to believe in their chances of continued existence, it is easy enough to see why the legislature ordained that all parties who may have dealings with the company shall have security for their trust.

CHAPTER VI.

THE AUDITOR'S DUTIES.

Negligence of the shareholder—Auditor's certificate and report—The New Act—The Railway Companies Act, 1867—and the Building Societies Act, 1894—Shareholders' carelessness—The Liberator group of companies—Judicial views of auditor's duties—The auditor's report—Wasting assets—Spurious reserves — Depreciations — Bleeding a company—The auditor's lapse—The London and Globe Company—Penalties to which auditors are liable.

The Ritual of Audit.—The auditor of the present day dwells afar from the din of finance. He leads a kind of abstract life. He is a trustee to preserve the contingent remainders of shareholders' and directors' provinces. Nominally he is the agent of the one; actually he is the friend of the other. He maintains invariably a supine courtesy and he distributes certificates with the equanimity of a Government official. It is not his fault that officially he is often moribund. The law decrees that he shall exist, and its officers, to whom he looks for instruction in his duties, have so addled his head with conflicting commands that he is forced, for the sake of self-preservation to pursue a course of polite

disobedience. The fiat of his creation is section 21 of the Companies Act, 1900, which declares that every company shall, at each annual general meeting, appoint an auditor, or auditors, to hold office until the next annual general meeting, and that, if an appointment of auditors is not made at that meeting, the Board of Trade may, on the application of any member of the company, appoint an auditor for the current year, and fix the remuneration to be paid to him by the company for his services. The legislature has thus placed in the hands of the shareholder the means of protecting himself either against fraud, or against unsound finance on the part of the officials of the company which is being worked with his capital. Yet, although he must appoint an auditor, the Act cannot compel him to carry out the intentions of those who framed it by taking pains to find a person whose scrutiny of the accounts will be entirely above the suspicion of dangerous sympathies with those who are responsible for the balance sheet. In all probability the conflicting notions of an auditor's duties have led shareholders to adopt that *laisser faire* attitude, by which his work has been allowed so frequently to lapse into an innocuous formality. He is generally endowed with plenty of potential honesty but it is seldom suffered to become kinetic.

A Financial Reviewer.—The auditor is little more than a reviewer of balance sheets. He scurries

through the books of the company and it would scarcely be surprising if now and then he appreciated a departure from the monotony of realities, when art has been dexterously invoked for the concealment of art. He is the agent of the shareholder, for the purposes of the work assigned to him, and he is privileged in having an unexacting principal. There are limitations to his agency. In Spackman *v.* Evans ([1868] L.R. 3 H.L. 170) it was decided that notice of facts to an auditor is not such notice to the shareholders as could deprive them afterwards of the right to object to any misconduct of the directors, or other officials, of which the auditors had knowledge. The auditor, however, being an agent of the shareholders, should be a person wholly independent of those who are responsible for the preparation of the accounts which he is paid by the shareholders to examine. His report upon the accounts is to be made neither to the directors nor to the managers, but to the shareholders of the company, to whom those officers are themselves answerable for the conduct of the enterprise.

Extended Liability.—Section 19 of the Companies Act, 1907, repealing section 23 of the Act of 1900, decrees (1) that every auditor of the company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the directors and officers of the company such information and explanation

as may be necessary for the performance of the duties of the auditors.

(2) That the auditors shall make a report to the shareholders on the accounts examined by them, and on every balance sheet laid before the company in general meeting during their tenure of office, and the report shall state,

(*a*) whether or not they have obtained all the information and explanations they have required; and,

(*b*) whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs *according to the best of their information and the explanations given to them,* and as shown by the books of the company.

(3) That the balance sheet shall be signed on behalf of the board by two of the directors of the company or, if there is only one director, by that director, and *the auditors' report shall be attached to the balance sheet, or there shall be inserted at the foot of the balance sheet a reference to the report,* and the report shall be read before the company in general meeting, and shall be open to inspection by any shareholder, who shall be entitled to be furnished with a copy of the balance sheet and auditor's report at a charge not exceeding sixpence for every hundred words.

(4) That a person, other than a retiring auditor,

shall not be capable of being appointed auditor at an annual general meeting unless notice of an intention to nominate that person to the office of auditor has been given by a shareholder to the company not less than fourteen days before the annual general meeting, and the company shall send a copy of any such notice to the retiring auditor, and shall give notice thereof to the shareholders, either by advertisement or in any other mode allowed by the articles, not less than seven days before the annual general meeting: Provided that if, after a notice of the intention to nominate an auditor has been so given, an annual general meeting is called for a date fourteen days or less after that notice has been given, the notice, though not given within the time required by this provision, shall be deemed to have been properly given for the purposes thereof, and the notice to be sent or given by the company may, instead of being sent or given within the time required by this provision, be sent or given at the same time as the notice of the general meeting; and

(5) that if any copy of a balance sheet which has not been signed as required by this section is issued, circulated, or published, or if any copy of a balance sheet is issued, circulated or published without either having a copy of the auditor's report attached thereto or containing such reference to that report as is required by this section, the company, and every director, manager, secretary, or other officer of the company who is knowingly a party to the default,

shall on conviction be liable to a fine not exceeding fifty pounds."

In his report it was the law, until this year, that the auditor was merely to state whether, in his opinion, the balance sheet was properly drawn up so as to exhibit a true and correct view of the state of the company's affairs as shown by the books of the company. The extension of the auditor's duties in the new Act covers, in some degree, the views of the Courts in a good many cases, but as those views were not always uncontradicted by other authorities it is an advantage to shareholders to obtain an increased control over the work of their paid agents. The efficacy of the phrase "according to the best of their information and the explanations given to them" will prove to be great or small according to the views that the Bench may take in future, but it may be anticipated that, in any event, the obvious spirit of this section of the Act will not be ignored, in spite of the mass of case-made law which has hitherto entrammelled judicial action. It might have been thought unnecessary to embody in the Act what was virtually the law laid down in Leeds Estate Building and Investment Company *v.* Shepherd ([1887] 36 Ch. Div. 787) but such a course lifts a definite and important decision from the arena of legal dispute, and saves it from any chance of attack by lawyers who are armed with innumerable conflicting expressions of the Bench.

The provision that either the report shall be at-

tached to the balance sheet, or the balance sheet shall have inserted at the foot a reference to the report, will prevent the continuance of the practice of publishing a report which conveys no information, together with the statutory certificate, and drawing up a totally distinct report which is never given to the public.

Parliamentary Language.—The provisions of the Railway Companies Act, 1867, as regards the audit of accounts, is more exacting in the interests of the shareholders than the Companies Act, and it is difficult to understand why they were not adapted and embodied in the measure of 1900, unless it was thought that such a masterpiece of English style could be produced only once in a century.

Under section 30 it was enacted that "No dividend shall be declared by a company until the auditors have certified that the half-yearly accounts proposed to be issued contain a full and true statement of the financial condition of the company, and that the dividend proposed to be declared on any shares is *bonâ fide* due thereon, after charging the revenue of the half-year, with all expenses, which ought to be paid thereout in the judgment of the auditors; but if the directors differ from the judgment of the auditors with respect to the payment of any such expenses out of the revenue of the half-year, such differences shall, if the directors desire it, be stated in the report to the shareholders; and the company in

general meeting may decide thereon, subject to all the provisions of the law then subsisting, and such decisions shall for the purpose of the dividend be final and binding; but if no difference is stated, or if no such decision is given on any such difference, the judgment of the auditors shall be final and binding, and the auditors may examine the books of the company at all reasonable times, and may call for such further accounts, and such vouchers, papers, and information as they think fit, and the directors and officers of the company shall produce and give the same as far as they can, and the auditors may refuse to certify as aforesaid, until they have received the same, and the auditors may at any time add to their certificate, or issue to the shareholders, independently at the cost of the company, any statement respecting the financial conditions and prospects of the company which they think material for the information of the shareholders."

The Building Societies Act, 1894, also imposed more comprehensive duties on auditors. By section 2, every auditor, in attesting any such annual account or statement, shall either certify that it is correct, duly vouched and in accordance with law, or specially report to the society in what respect he finds it incorrect, unvouched, or not in accordance with law, and shall also certify that he has at that audit actually inspected the mortgage deeds and other securities belonging to the society, and shall state the number of properties with respect to which deeds have been produced to and actually inspected by him.

Mr. Jorkins and Mr. Spenlow.—Shareholders, apparently impressed by the efforts of Parliament to protect their property, believe that the various enactments made for this purpose will work automatically. They think that they have done all that can be reasonably expected of them when they have formally appointed a firm of auditors to watch over their interests. They themselves are not accountants; they have not always more than the vaguest ideas of the import of a balance sheet; they are unacquainted with the finesse of the financier and the wiles of the professional director; and they lay the flattering unction to their souls that, because they pay several hundreds of pounds every year to a reputable partnership of accountants, all must go well with the company that they have launched. Here their anxiety appears to cease. But *quis custodiet ipsos custodes?* It does not occur to the shareholders that, just as they, in their private affairs, do not like to have contingent liabilities hanging over their heads, this eminent firm of chartered accountants is eager to shift from its shoulders as much responsibility as the law of the land and its employers will permit. The directors when confronted with objections to a balance sheet ask indignantly whether the critic wishes to impugn the integrity of the auditors, and the auditors if questioned upon the results of their scrutiny, shrug their shoulders, point to their certificate and report, and quote the latest dictum of a

law lord. Thus, the shareholder is referred from Mr. Jorkins to Mr. Spenlow, and from Mr. Spenlow to Mr. Jorkins until he wearies of trudging to and fro without becoming any the wiser about what, he is finally convinced, has ceased to be his own business.

There is nobody but the shareholder who can prevent the auditor from shirking even more of the resposibility than he is entitled to avoid, and, on this account, it is surprising that the shareholders not only decline to interfere, as a rule, but show no desire to become acquainted with the nature and extent of the duties and responsibilities of the professional men who are their salaried servants.

A Bow at a Venture.—The Liberator group of companies brought the subject prominently before the Courts in 1895, and Lord Justice Lindley, in the case of the London and General Bank (2 Ch. 673) defined the duties and responsibilities of the auditor as follows:—"It is no part of an auditor's duty to give advice, either to directors or shareholders as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans, with or without security. It is nothing to him whether the business of a company is conducted prudently, or imprudently, profitably, or unprofitably. It is nothing to him whether dividends are properly, or improperly declared, provided he discharges his duty to the shareholders.

"His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question how he is to ascertain such position. The answer is by examining the books of the company. But he does not discharge his duty by doing this without enquiry, and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do so. . . His first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company. . . An auditor, however, is not bound to exercise more than reasonable care and skill in making enquiries and investigations. What is reasonable care in any particular case must depend upon the circumstances of that case. When there is nothing to excite suspicion very little enquiry will be reasonable and sufficient, and in practice, I believe, business men select a few cases at haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary."

All Honourable Men.—It was afterwards held in this case that the auditor of the company was liable, jointly with the directors, to make good a dividend, which had been declared upon the strength of a mis-

leading certificate that he had given. Lord Justice Lindley continued: "I have no hesitation in saying that Mr. ——— did fail to discharge his duty to the shareholders in certifying and laying before them the balance sheet of February, 1892, without any reference to the report which he laid before the directors, and with no other warning than is conveyed by the words 'The value of the assets as shown on the balance sheet is dependent on realisation.' The most important asset in the balance sheet is put down as 'Loans to customers and other securities, £346,975,' and on these a full and detailed report was made to the directors, showing the very unsatisfactory state of these loans and securities, and it is impossible to read the oral evidence 'without coming to the conclusion that the entry of that large sum as a good asset without explanation was unjustifiable.' The duty of an auditor is to convey information." "A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them or some of them to ask for information. Information and means of information are by no means equivalent terms."

In the report of a Parliamentary Committee, Lord Davey is reported to have said that "an auditor is bound to know everything that the books tell him, and to have all the suspicions that the books suggest, and to make all the inferences to which what he finds in the books would lead him."

Watchdog, not Bloodhound.—The judgment of Lord Justice Lopes in the Kingston Cotton Mill Company case (No. 2 [1896] 2 Ch. 289) followed that of Lord Justice Lindley, who, it was thought, did not entirely elucidate the auditors' position as regards "detective work." Lord Justice Lopes declared that the auditor was "a watchdog, not a bloodhound." "It is the duty of an auditor" he added "to bring to bear on the work he has to perform that skill, care and caution, which a reasonably competent, careful, cautious auditor would use. An auditor is not bound to be a detective, or as was said to approach his work with suspicion, or with a foregone conclusion that there is something wrong. . . . . He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to create suspicion he should probe it to the bottom, but in the absence of anything of that kind he is only bound to be reasonably cautious and careful. . . . . He does not guarantee the discovery of all fraud."

The "watchdog" definition, however, did not appear fully to satisfy the Courts and an endeavour was made by Lord Justice Fitz-Gibbon to expand it, in the Irish Woollen Company *v.* Tyson. He asked: "Was not the watchdog bound to bark? And if when sniffing round you hit upon a trail of

something wrong, surely you must follow it up, and there is just as much obligation on the auditor, who is bound to keep his eyes open, and his nose too. As in the case of the hound, the auditor will follow up this trail to the end, and the first things he will root up are those statements of accounts, and then the fraud is discovered."

Mind and Matter.—Although it had been stated by more than one judge in the Court of Appeal that it was not the auditor's duty to do more than exercise his mind upon any suggestion of improper accountancy or of defalcation, and that he was not bound to take stock, it was held in the London Oil Storage Company, Ltd., *v.* Seear, Hasluck & Co., that the auditor should take adequate steps to verify the existence of assets mentioned in the balance sheet. In this case Lord Chief Justice Alverstone directed the jury that an auditor "must exercise such reasonable care as would satisfy a man that the accounts are genuine, assuming that there is nothing to arouse his suspicion of dishonesty, and if he does that he fulfils his duty. If his suspicion is aroused his duty is to probe the thing to the bottom, and tell the directors of it and get what information he can."

It was decided in the Leeds Estate Building and Investment Society, Ltd. *v.* Shepherd, that "It was the duty of the auditor not to confine himself merely to the task of ascertaining the arithmetical accuracy of the balance sheet, but to see that it was a true and accurate representation of the company's affairs."

Paid to be Suspicious.—When all the decisions of the Courts are read together it is evident that the responsibility of the auditor is not limited merely to collating the books of the company and ascertaining whether the entries in one account tally with those in another. He is paid to be suspicious. He has nothing to do with the commercial methods of the company, but he has a great deal to do with its financial methods, for he is bound to give a certificate of the financial position of the company at the time of the audit. Anything in the books of the company which might excite suspicion in the mind of a competent accountant or of an ordinary man of business, is to be subjected to the same rigorous investigation by the auditor, as agent, that would have been carried out by the shareholder as principal. On the other hand, an auditor is not expected to warrant or to insure, or even to guarantee that the balance sheet is correct; he gives an opinion, just as any professional man does, but he must be prepared to justify that opinion as being that which might be formed in the circumstances by any competent member of his calling. Auditors are in a different position from directors. They are not to assume that because the cashier charges £100 as having been paid, it has been so paid. Their duty is to require some *primâ facie* evidence, such as a receipt, that the money was duly paid. If, on the other hand, the receipt, although apparently correct, were forged, it could not be contended that they were

responsible for passing it unless it was shown that something existed or appeared which to the mind of a reasonable person would suggest that forgery had taken place. Auditors must not trust others as to the accuracy of any document which it is their duty to examine themselves.

Sins of Omission.—The report which the auditors were bound to make (Section 23, Companies Act, 1900), upon the balance sheet was to state that it is drawn up in such a way as to exhibit "a true and correct view of the state of the company's affairs as shown by the books of the company." It was held that a balance sheet to which such a report is attached must not conceal any known cause of weakness in the financial position of the company, nor must it suggest anything which cannot be supported as being fairly correct from a business point of view. (In *re* London and General Bank, *ante*). This decision gains strength from the new enactment.

If the auditors see that wasting assets are set down in a balance sheet at the same value as that which had been given to them years before, they are supposed either to insist upon a readjustment by the directors of the figures representing those assets, or to communicate their dissatisfaction to the shareholders. Although they cannot attempt to advise the company upon the management of its commercial affairs, they must intervene when items appearing on the balance sheet are palpably erroneous. Should they find from

the books that the amount representing credit given is such that, in the ordinary course of business, it cannot be realized to the full, they are bound to see that better provision is made for bad and doubtful debts. This is not always done in balance sheets which bear the signatures of the best known firms of auditors, nor is it unusual to find the names of the most eminent accountants appended to a company's statement of account, which sets out the figures of an enormous reserve fund, without informing the shareholders that the whole of that fund is invested in the stock of the company itself. The shareholder who receives a balance sheet of this kind, congratulates himself that the enterprise in which he has acquired an interest is able to guard itself against the commercial dangers of panics and alarms; he believes, and no doubt, he is intended to believe, that the huge reserve has been invested outside the company, and that the directors can draw upon it in the event of an emergency, which might mean ruin to a concern that was not thus insured. The reserve fund is regarded by the shareholder as a form of insurance, and it is scarcely honest on the part of auditors to allow the directors to deceive the shareholders by leading them to place their trust in a fund which must perish in the disaster that it is created to avert. It is true that in some cases the companies are honourable enough to add a note in the balance sheet, informing the shareholder that the reserve fund, or part of it, has been invested in the business, and in certain

circumstances, no doubt, it is an excellent investment from one point of view; but there are companies trading under names that lift them above the faintest suspicion of the public, which are guilty of attempting to conceal year by year the fact that their reserves are wholly invested in stock, which must vanish in a crisis with that which it exists to replace. (The question of reserves is treated fully in Chapter VII).

Eternal Plant Life.—It is a common practice, too, not to write off a sufficient sum for depreciations in a wasting property, or to give to buildings owned by the company an absurdly increased value, on the ground that the district in which they are situated is becoming a better trade area with higher rentals. If an auditor has any doubts upon either of these points he should have an independent valuation made. In times of vigorous competition the expenses of carrying on the business of a new company are often so great that directors are unwilling to charge the revenue account with depreciations, seeing that, were they to do so, there would be no possibility of paying a dividend. Hundreds of balance sheets issued every year show that in the case of patents and machinery which must soon be superseded by newer inventions, nothing, or scarcely anything, is allowed for the gradual expiration of the one or for the wear and tear of the other; and the board of the company is permitted without remonstrance by the auditors to defer the creation of a reserve for what is obviously a vanishing asset.

In some cases the Articles of Association allow the distribution, as dividend, of the excess of the proceeds of working above the expenses of working, without the accumulation of a sinking fund to make good depreciations; and distinctions are drawn between complete and continuous ventures. This practice, it is submitted, is contrary to the spirit, if not to the letter, of the statute law. (The subject is dealt with minutely in Chapter V.) There are cases in which a company's patents, for instance, are but a part of its property, and the directors, neglecting all else, propose dividends upon the profits derived from these patents without making allowance for their approaching expiration, or even for losses in other directions. It may be answered that shareholders are voracious, and that they are eager to have a dividend, even though it could not be paid under sound management. That, however, does not excuse the wilful deception practised by directors of such companies, with the tacit approval of the auditors. Did the shareholders realize that the amounts paid to them as dividends in these cases represented, not a return on capital, but a small part of capital itself, and that the dividends paid in such a way were rapidly making it impossible that the members of the company should ever receive back anything like the amount they had invested, to say nothing of interest, they would not sanction the action of the board. A company in such a position is in a state of factitious liquidation. The assets are being realized gradually,

and the proceeds are being divided among creditors, who, so far from having the slightest chance of making money out of the transaction, must consider themselves fortunate if they get five or ten shillings in the pound.

A Congenial Descent.—The case of Lee *v.* The Neuchatel Asphalte Company (41 Ch. D. 1) referred to on page 56 gave a gracious impetus to the auditor in his lapse from the position of an independent supervisor of the directors, appointed by the members of the company. The opinions of the Courts are at last showing a tendency to veer round, and some of the cases, which are cited in Chapter V. give every hope that the persistent connivance at the strategy of directors which has recently characterized the auditor's attitude will receive a check. Stanesby, who is generally recognized as an authority upon accountancy, writing with special reference to building societies, did not mince his words.

"The object of an audit," he declared, "is not fulfilled by the mere tracing of all the cash which is shown to have been received into the hands of the bankers, and then seeing that such amount has been expended or paid away for legitimate purposes, and that every payment has been duly vouched. . . . The auditors must examine whether the cash so reported and accounted for is really the whole amount that has been paid. Audits have proved simply the means of aiding a thief of the most unblushing

character by covering his nefarious proceedings with a delusive mantle of fictitious authentication, and buttressing the reputation of a man who was perpetrating the most cruel frauds with the names of men whose character may have been as unsullied and unimpeachable as their judgment has proved to be defective."

Shareholders must realize that they have all the power in their own hands if they care to organize and use it. They can decline to re-elect a firm of auditors who have ceased to act in their interests, or whose examination of the accounts submitted to them has been marked by a neglect of the principles of sound finance.

A House of Cards.—The gradual lapse of the auditor from his original position as the custodian of the shareholders' interests is demonstrated by the fact that the balance sheets, which are criticised in Chapter IV., were signed by some of the best known firms of chartered accountants. The fate of the firms which have been issuing these balance sheets is still undecided ; and if the questionable system of accountancy which characterises their annual statements is not in itself evidence against the auditors who sanctioned them, it would be easy to point to concerns which have collapsed, after a slow decline into bankruptcy, that had been watched through all its phases by the auditors and concealed, up to the last moment, with their acquiescence. The report of the Official

Receiver in the winding-up of the London and Globe Finance Corporation, Ltd., is a glaring example of the way in which a company's balance sheets may contain, with the approval of the auditors, those innumerable items which make the materials for a tale, full of sound and fury—signifying nothing. The directors, in most cases, gave the nominal values in the books of the company as the realizable values, "but," the reports adds, "the estimates so made were wholly fallacious as the following results of realization will show :—

	Estimated Value.	Realized.
(*a*) "Shares in Allied Companies" ...	£515,956	£5,565
(*b*) Shares in Subsidiary Companies...	700,640	52
(*c*) Shares in other Subsidiary Companies	762,244	63,129
(*d*) Shares in other Companies ...	1,704,335	162,208
(*e*) Book debts	325,006	5,336
(*f*) Investments in Shares	1,103,890	1,533

Shares in other companies included items upon which the receiver made the following comments: "Of the 48,242 Le Roi No. 2 shares 17,457 were pledged with creditors, the remaining 30,785 were sold by the voluntary liquidators. The whole of the 52,695 Lake View shares were pledged with creditors by whom they have been realized. No surplus became payable to the company. The 148 Le Roi mining shares were sold by the voluntary liquidators." Here is another note by the Receiver: "Immediately before the balance-sheet of the 5th December, 1900, issued by the London and Globe, the Standard Exploration Company agreed to purchase from the

London and Globe a mining property known as 'The Option Blocks Proprietary' for £100,000. The London and Globe has never been in a position to deliver this property, nor the Standard Company to pay for it. Under an order of the court the contract between the two companies has been rescinded. The property has since realized £500."

The balance-sheets containing these items had all been examined by the auditors, and, apparently, they were unable to discover anything to arouse their suspicion. No stronger evidence of the utter worthlessness of the modern audit could be adduced; and shareholders who suffer their money to be paid to chartered accountants whose duties have been reduced to an idle formality, deserve little commiseration on their ultimate ruin. It is plainly the duty of the auditor to remember that investments of the kind which appeared on the balance-sheets of the London and Globe Finance Corporation have a realizable value that is very different from their market value. It was nothing but a dereliction of that duty which permitted the publication of the statements of accounts which long misled and ultimately ruined hundreds of shareholders.

Pains and penalties.—Auditors are officers of the company, and, as such, they may be compelled to refund to the company the amount of a dividend which could not have been declared but for the falsity of their certificate. "Any person who in any return

report, certificate, balance-sheet, or other document, required by or for the purpose of the Act (Companies Act, 1900) wilfully makes a statement false in any material particular, knowing it to be false, shall be guilty of a misdemeanour, and shall be liable on conviction or indictment to imprisonment for a term not exceeding two years, with or without hard labour, and, on summary conviction, to imprisonment for a term not exceeding four months, with or without hard labour. In either case a fine may be imposed in lieu of imprisonment. This section (28) applies to companies registered before the Act was passed. In Whitaker Wright's case, it will be remembered, action was taken under sections 81 to 84 of The Larceny Act, 1861. Subjoined is the text of these sections:—

81.—Whosoever, being a director, member or public officer of any body corporate or public company, shall fraudulently take or apply for his own use or benefit, or for any use or purposes other than the use of such or purposes of such body corporate or public company, any of the property of such body corporate or public company shall be guilty of a misdmeanour, and be liable on conviction to penal servitude for a term not exceeding seven years, or to imprisonment, with or without hard labour, for a term not exceeding two years.

82.—Whosoever, being a director, public officer, or manager of any body corporate or public company, otherwise than in payment of a just debt or demand,

and shall, with intent to defraud, omit to make, or to cause or direct to be made a full and true entry thereof in the books and accounts of such body corporate or public company shall be guilty of a misdemeanour—punishment as above.

83.—Whosoever, being a director, manager, public officer, or member of any body corporate, or public company, shall, with intent to defraud, destroy, alter, mutilate, or falsify any book, paper, writing, or valuable security, belonging to the body corporate or public company, or make or concur in the making of any false entry, or omit or concur in omitting any material particular, in any book of account or other document shall be guilty of a misdemeanour—punishment as above.

84.—Whosoever, being a director, manager, or public officer of any body corporate or public company, shall make, circulate, or publish, or concur in making, circulating and publishing, any written statement or account, which he shall know to be false in any material particular, with intent to deceive or defraud any member, shareholder, or creditor of such body corporate or public company, or with intent to induce any person to become a shareholder or partner therein, or to entrust or advance any property to such body corporate or public company, or to enter with any security for the benefit thereof, shall be guilty of a misdemeanour—punishment as above.

CHAPTER VII.

RESERVES AND RESERVE ACCOUNTS.

Reserve Fund and liability to shareholders—Provision of Table A—The division of profits—Certain and contingent liabilities—Purposes of a reserve—"Preliminary expenses"—The false reserve—A question of investments—A case in point—The essential character of a reserve—Surplus invested in the business.

A Permissive Clause.—Nearly every company provides for the creation of a reserve account out of profits, and this is represented as a liability to shareholders. Section 74, Table A, of the Companies Act, 1862, states that the directors may, before recommending any dividend, set aside out of profits of the company such sum as they think proper as a reserve fund to meet contingencies, or for equalizing dividends, or for repairing or maintaining the works connected with the business of the company, or any part thereof; and the directors may invest the sum so set apart as a reserve fund in such securities as they may select. There is nothing, however, to compel a company to divide the whole of its profits, notwithstanding the existence of regulations to that effect. (Stringer's Case, 4 Ch. 494).

The liabilities which the reserve is accumulated to meet may be certain or contingent. In the first class the company must include the wear and tear of plant, depreciations of floating assets, and allowances for bad and doubtful debts. Such an account is opened to maintain the company in a condition that will guarantee the existence of the business as a profit-earning enterprise, and the amounts named in it cannot be returned directly to the shareholders. It is a little misleading to place items representing these deficiences on the Dr. side of the balance sheet, for they are in fact deductions from the assets. The true reserve is a surplus of assets, obtained from a correct valuation, over all liabilities. It is therefore clear that there can be no real reserve fund until such an item as "preliminary expenses" has disappeared from the statement of accounts. A reserve may also be set aside for the purpose of equalizing dividends, so that the large profit of one year may contribute to the maintenance of the company's dividend-paying reputation in a less prosperous season. A fund of this kind, accumulated out of profits, does not lose its character of undivided profits until some act is done by the company which effectually converts it into capital. (Sugden *v.* Allsbury, W.N. (1890), 112, 45 Ch. D., 236, and Bouch *v.* Sproule, 12 App. Cas. 385).

The True Reserve.—A reserve formed to meet such contingent liabilities as unforseen financial difficulties, that is to say, a fund constituted of cash or

that for which cash can be readily obtained, is represented on the credit side of the balance sheet by investments. Such a fund is a true insurance against emergency, because it can be used at a moment's notice to tide over a temporary adversity. When no investments appear on the credit side it is obvious that the reserve is distributed among the assets, in other words, is being used for the purpose of carrying on the trading of the company. Sometimes it stands for an increase in the value of fixed capital, such as premiums on shares, freeholds and leaseholds, which are believed to have acquired an enhanced value. An item of this kind represents a part of the capital, which has been set forth as reserve, because the company cannot increase its capital without legal proceedings. If it represents premiums on shares then it is a capital profit, and it cannot be distributed in dividends. Its value is, moreover, always open to question when there are no investments to place against it on the credit side of the balance sheet. It was cash, and it is the duty of the shareholders to ask what has become of that cash. In the first balance sheet printed in Chapter IV. (p. 33) there is a general reserve fund of £85,000. This money has been invested in the business and cannot therefore be drawn upon to aid the company in a period of financial stress. From the second balance sheet in the same Chapter (p. 37) it will be seen that, a year later, the general reserve fund was increased to £116,000 by premiums received on the issue of

further shares, and that all this cash is represented by nothing on the other side of the balance sheet but assets that are not generally realizable and are subjected to the very risks which a shareholder expects a reserve fund to counteract. As the investments—£12,000 in Consols, balance the redemption of leaseholds, lands, etc., £31,000 cash obtained by way of premiums has disappeared among the other items of the credit account. Is the money in the assets, freeholds and leasehold properties, fixtures, fittings, utensils, etc., household furniture, horses, vans, and harness? If it is, then its value as a reserve is nothing, because these assets cannot be realised until the liquidation of the company. Is it in stock-in-trade? If it is, it is wasting and perishable. If an individual were to invest his profits in household furniture and to argue that such an investment was equivalent to a holding of Consols, he would excite derision. When a public company takes an analagous course, it is thought to be endowed with wisdom. The truth is that, in nine cases out of ten, the reserve which appears on a company's balance sheet has sprung from an over valuation of assets, and there it stands increasing year after year, balanced by what are generally dwindling and always inconvertible assets.

The issue of shares when there is the chance of premiums on them is another part of a system of fallacious accounts. With a balance sheet showing a large reserve and a fine array of assets, it is easy to achieve that end when capital has been lost or paid

away in dividends. The premiums in this case are applied to making good a shortage in the paid-up capital.

A Cause of Confusion.—Much of the difficulty and confusion that exist in the minds of shareholders arises from the misapplication of the term "Reserve Fund." If the surplus of assets over capital and liabilities is employed in the working of the business it is an abuse of terms to call it a reserve fund. The impression that such a name conveys to the shareholder is that the amount which appears on the balance sheet under the title "Reserve Fund" is the value of cash or easily convertible securities of which the company can make use at any moment without impairing its profit-earning capacity. It may be a part of the original capital which is not required for carrying out the enterprise for which the company was formed; but so long as it remains available to meet a cash contingency it is correctly described as a reserve fund. If, on the other hand, there is merely a reservation of profits, and those profits are distributed over the accounts to stop the holes in a capital account, it is a misrepresentation to describe the process as the establishment of a reserve.

The test is here that which has been already insisted on in Chapter IV., for balance sheets generally. It is a question of setting cash assets against cash liabilities. "Reserve fund" conveys to the mind the idea of a cash accumulation, or, at least, the posses-

sion of rapidly realizable securities. It is sometimes said that if the surplus is invested in the business the company will possess a greater credit, and all the more money may be raised on the increased security of the capital vested in the concern. Such an argument is suicidal. It might be contended with equal plausibility that the individual who invested his savings in furniture was rendering his financial position all the more secure because, when confronted with some unsuspected liability he could the more easily obtain a bill of sale. Yet it is commonly the case that a company expends profits upon buying or improving assets, and then represents the amount expended on the other side of the balance sheet under the title of Reserve Fund. More often, however, the figure supposed to represent a reserve fund is arrived at only by an over valuation of assets.

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